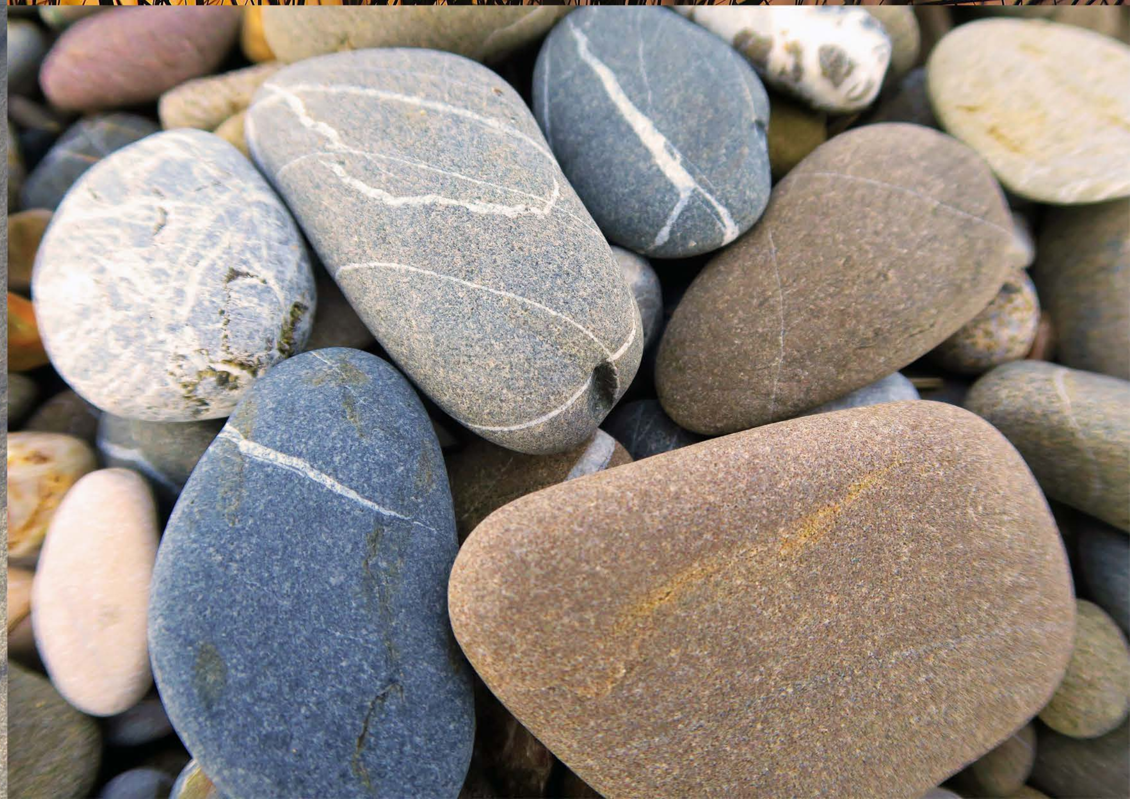
2018

ANNUAL REPORT AND ACTIVITY REPORT
OF THE FINANCIAL AND CAPITAL MARKET COMMISSION FOR 2018

FKTK
FINANŠU UN
KAPITĀLA
TIRGUS
KOMISIJA



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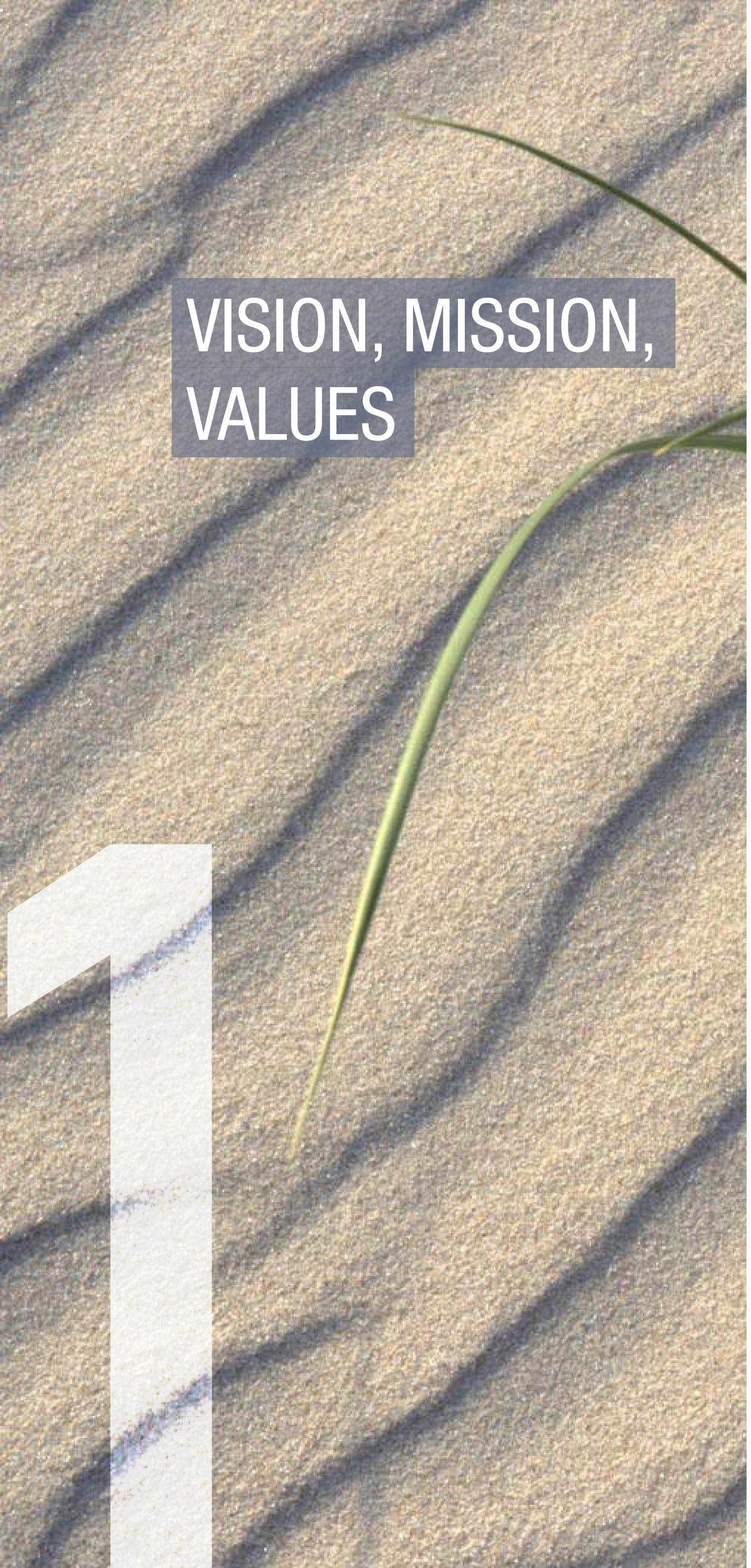

1 VISION, MISSION, VALUES

FCMC VISION

A sound Latvian financial market integrated into the EU single market, associated with professional, rigorous and fair supervision.

FCMC MISSION

To regulate and supervise the activities of the financial and capital markets and the participants thereof, promote the protection of the interests of depositors and insured persons, as well as the development and stability of the financial and capital markets.

FCMC VALUES

Accountability – we are aware of the impact of our activities on the performance of individual market participants and on the financial system as a whole, and we are responsible for the protection of the interests of investors, depositors and insured persons, as well as for the development and stability of the financial and capital markets.

Openness – in our activities, we are open to dialogue before making decisions. We are available and cooperative, as well as able to professionally make use of our knowledge, finding solutions to a wide spectrum of challenges.

Transparency – we explain each and every one of our decisions to the public in an explicit manner, complying with the regulatory restrictions on the disclosure of information.

CHAIRMAN'S FOREWORD

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Historical borderline – 2018

This reporting year has been distinctive for the Latvian state, financial sector and our institutions as a supervisor of the sector. Definitely, we will further mark the year 2018 as a milestone for a new stage in the economic and financial history of Latvia. As of 2016, when Latvia became a member state of the OECD, in a process initiated and closely controlled by the FCMC the most ambitious reform of the business approach to the financial sector has taken place within three years to mitigate potential financial crime risks.

The reform most significantly affected the major segment of industry – the banking sector. We had plans for several years on how to gradually mitigate the aforementioned risks related to the excessive portion of foreign deposits in the banking sector. February of 2018 introduced adjustments to these plans as the United States Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) published a statement that the Latvian commercial bank ABLV Bank had raised concerns about money laundering and suggested applying special measures to the bank. Basically, it was due to the aftermaths of historical legacy, as significant corrective measures had been implemented in the bank in the previous years, and the fines imposed on the bank were the highest that had ever been applied in Latvia, together with the investments requested by the FCMC amounting to several tens of millions of euros. However, further isolation of the bank from the international financial market was a clear signal – such isolation of Latvian banks due to the reputational risk would be possible on a much wider scale.

In times like these, a slow drop in foreign customer deposits in Latvian banks, for which they had been the business base, and a slowly weighted revision of this customer segment were no longer on the agenda. Also, due to geopolitical considerations more radical solutions were needed in our country to demonstrate immediate changes. In the first half of the year we switched from a planned process to crisis management in banking supervision. What has been done during the year 2018 that could be described as self-cleaning of banks and a change in the current business approach?

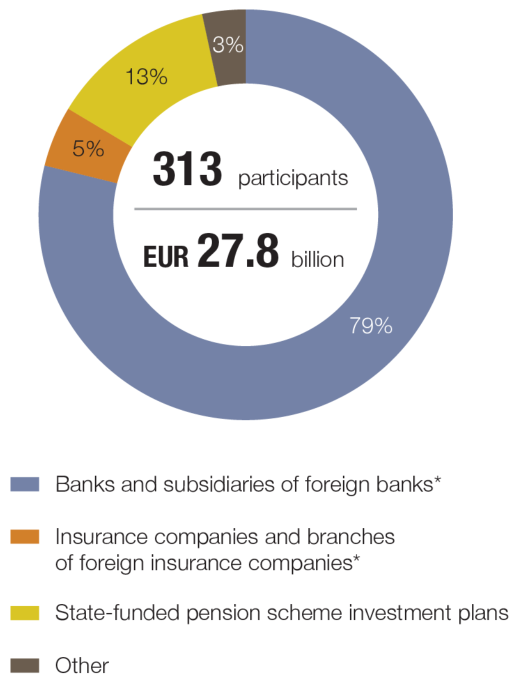
Most important task was forcing out potentially high risk financial resources of Latvia. In 2015, foreign money in Latvian banks was in the amount of 54% and the year 2017 we finished with 39%, but during 2018 the reduction was even twice as big – up to 20%. Following revision in the high-risk client segment, the exposure of CIS clients was reduced by 5–6%, which was the task given by the Government at the beginning of the year. Compared to 2014, foreign client payments in US dollars were reduced by more than 26 times. This was the currency used most often in the transactions by the bank clientele located to the east from Latvia, including for suspicious transactions. Within a few months all banks refused to service the shell companies banned in Latvia. Over a three-year period approximately EUR 10 billion had left the financial sector of Latvia. By significantly reducing the risky fast lending business, we have relieved our financial system and country from unnecessary reputational risk. Currently, domestic and EU member states' deposits dominate in Latvian banks, totalling already 91%. There are no more reason to speak about an uncontrollable flow of high-risk foreign money in Latvia.

The performed self-cleaning has been a test of endurance proving the high professionality level and inherent potential of the banking sector management system. The process has not stopped, banks are continuing to assess their client responsibly – both the existing and newly attracted client base according to the new business models and the amount of foreign deposits has been dropping in 2019 as well. In order to ensure changes, we have applied sanctions – in the last four years of change we have imposed fines in the sum total of EUR 16 million (in 11 previous years the total of fines was approximately EUR 1 million) on Latvian banks and payment institutions, as well as other types of sanctions and corrective measures.

In the middle of the reporting year, in cooperation with the ECB colleagues, accepted by the Board of the FCMC, the controlled self-liquidation of ABLV Bank is up to now an unprecedented solution in Latvia to the termination of a bank's operations. This is also a turning point in the usual procedures for bank liquidation in Latvia, often making banks insolvent during the process. It is a significant accomplishment of our team – putting the self-liquidation process on a constructive track, by reviewing and complementing the methodology for client verification developed by the bank liquidators and coordinating it with other institutions. The self-liquidation process supervised by the FCMC is exactly the way of how we can implement the control of clients' money to eliminate the possibility to disburse the proceeds of crime.

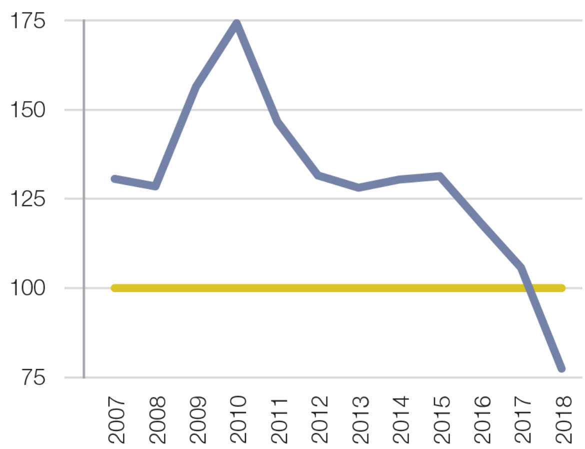
After the self-cleaning and transformation processes the state of play and certainly the future of Latvian banks are a completely different client profile, thus there is no classification of Latvian banks into domestic and foreign client banks any more, as they all are focused first of all on the Latvian market and then on the markets of EEA and OECD countries. In the next few years bank performance indicators will show the return on the new business strategies and the ability to absorb the consequences of the period of change. In this way we will have the banking sector in line with the size and capacity of the Latvian economy. At the beginning of the change management phase the work of the FCMC was unavoidably directed towards the narrowing of the banking business instead of the growth. Five years ago the share of banks' assets in the Latvian financial market was approximately 96%, while at the end of 2018 the share was 78%. It is a significant change in the Latvian financial landscape. The amount of domestic deposits has been steadily growing though, reaching EUR 13 billion at the end of 2018.

Market participants supervised by the FCMC*, % of their assets



* December 2018, excluding capital markets - equity issuers and bond issuers.

Banking sector to GDP, %



When assessing the year 2018, we can have true satisfaction in implementing historic changes, and this is an appropriate starting point for restoring the international reputation of the Latvian financial sector. It can be done by measuring the change with the accomplished, invested work. Our institution has accomplished our part of the work in the sector under supervision. We hope that other responsible institutions will also carry out all the tasks successfully, so that the assessment of the crime prevention system of our country will be positive from the international partners.

In recent years we have significantly strengthened the capacity of the FCMC in the field of financial crime prevention, but I still believe that basically we, as the supervisor of the financial sector, should continue the classical or so called prudential supervision of market participants, ensuring why this institution has been established in the country – the stability in the sector and protection of depositors. This is the best practice in the European banking union, and this has been confirmed once more by the European Parliament, by separating the competence of financial intelligence from supervision and by instructing the EC to immediately start creating a unified European financial intelligence institution that would implement the function of crime investigation, and moreover, in a wider scope than the financial sector alone. In turn, the FCMC, as before under its responsibility, will continue caring for high-quality internal control systems in the sector under supervision that would eliminate the involvement of financial market participants in possible financial crimes.

The state supervision of the financial sector in Europe is based on unified principles – political independence and economic autonomy. It is foreseen by the “Basic principles for effective banking supervision” by the Basel Committee on Banking Supervision, as well as by the Single Supervisory Mechanism established in the framework of the ECB. Reforms recently planned by the Government to the control of the Latvian financial sector and the FCMC management model, as well as for the selection of the management of the institution, are the choice of the policy makers, in which one should both keep in mind the prospects for the development of the sector and evaluate the impact of this change on the supervision framework of the financial sector implemented in Latvia in the longer term, so that hasty reforms do not result in new reforms after some time. In this respect this is also historic time in the Latvian economic life and the financial sector. We have drawn the legislators’ attention by providing our opinion on every planned change regarding the amendments to the Law on the Financial and Capital Market Commission and the possible impact thereof on the work of the institution.

I would like to thank the FCMC team for endurance and professional performance during this stage of tension and very high intensity, while carrying out important tasks for our sector and the international reputation of the country. I wish for us to develop the FCMC team spirit and maintain the feeling of a collegial shoulder in daily work in the future as well, in order to continue improving our organisation according to the new strategic priorities of the financial sector supervision.

Chairman of the FCMC
Pēters Putniņš

3 REPORT OF THE BOARD

The FCMC has been operating as an autonomous public institution since 1 July 2001, regulating and monitoring the Latvian financial and capital markets, ensuring the protection of the interests of the customers of market participants and promoting the stability, competitiveness and development of the whole sector. The activities of the FCMC are managed by the Board, consisting of five members of the Board: Chairman of the FCMC, his deputy and three members of the Board, who concurrently are the directors of the departments.

In 2018, the composition of the Board remained unchanged: Chairman of the FCMC Pēters Putniņš, Deputy Chairwoman Gunta Razāne, Director of the Supervision Department Nora Dambure, Director of the Legal and Licensing Department Gvido Romeiko and Director of the Regulations and Statistics Department Ludmila Vojevoda.

Once a week, the Chairman of the FCMC convenes and chairs the meetings of the Board aimed at reviewing the most important matters and at decision-making. In 2018, 56 meetings of the FCMC Board were held, during which 200 decisions were adopted (in 2017 - 55 meetings with 218 decisions adopted, respectively).

To promote the efficiency of the monitoring of the financial and capital markets, ensuring the cooperation of the FCMC with the professional associations of the financial sector, meetings of the Consultative Council of the Financial and Capital Markets are also convened on a regular basis. In 2018, 10 such meetings were held during which 38 draft laws and regulations binding on the financial and capital markets were reviewed (in 2017 - 40 draft laws, respectively).

4 November 2018 marked four years since the commencement of the Single Supervisory Mechanism (SSM) established by the ECB, and in the field of supervision of Latvian systemically important banks, also during the reporting year, the employees of the FCMC continued to participate in the work of the SSM joint supervisory teams and in the establishment of supervision practice. In the reporting year the supervision of systemically important Latvian banks, i.e. Swedbank, SEB banka, ABLV Bank (till 11 July 2018) and Luminor Bank (as of February 2018) was implemented in cooperation with the staff of the ECB and the FCMC, and it was a significant basis for the everyday supervision of banks. The FCMC also supervised less important banks, whereas the ECB continued to prescribe a uniform guidance and guidelines for the supervision of such banks.

The FCMC, ensuring continuous monitoring of market participants, carried out the monitoring of the performance results of market participants, the analysis of the financial statements and activity inspections thereof, inter alia, on-site inspections.

Overall, in 2018 the FCMC carried out on-site inspections of 20 market participants, including four inspections in banks, three inspections in insurance companies, one inspection in an electronic money institution, one inspection in the field of the provision of investment services, four inspections in savings and loan companies and one in an investment management company. One on-site inspection of a state-funded pension scheme asset manager was also carried out as well as two private pension fund inspections. In 2018, the FCMC carried out on-site information system security audits in three banks, one insurance company, one credit union and one payment institution.

On 13 February 2018, the FinCEN published a report stating that a Latvian commercial bank ABLV Bank raised concerns of money laundering, and made a proposal to apply to it the special measures of Section 311 of the Patriot Act of the USA. After publishing of the FinCEN proposal it was found that there was an increased activity by ABLV Bank clients in the withdrawal of deposits; therefore, on 18 February 2018 the Board of the FCMC, based on the ECB instruction, took a decision to determine payment restrictions to ABLV Bank. On 24 February 2018, the ECB took the decision on the recognition of ABLV Bank as an institution failing or likely to fail, which meant termination of the credit institution's activity. On 12 June 2018, the Board of the FCMC gave permission to start self-liquidation of ABLV Bank and after the proposal by the FCMC on 11 July 2018 the ECB took a decision to withdraw the licence of ABLV Bank.

In 2018, the FCMC also ensured regular supervision in the field of financial crime prevention. For the violation of the requirements of the Law on the Prevention of Money Laundering and Terrorism Financing (hereinafter – the AML/CTF Law) three credit institutions – LPB Bank, BlueOrange Bank and Meridian Trade Bank – had a fine imposed in the amount of EUR 3,907,902, as well as a range of obligations was determined to be performed in order to bring the internal control systems of the banks into conformity and improve them. The FCMC carried out the follow-up supervision of the fulfilment of these obligations. In addition, in one case a reprimand was issued to the board member responsible for AML/CTF and the said person was dismissed from carrying out duties in the AML/CTF field. In turn, in 2018, in the non-bank sector two electronic money institutions and two payment institutions had a fine imposed due to non-observance of the AML/CTF Law requirements in the sum total of EUR 113,255. In addition, in two cases the provision of payment services was suspended, in three cases a reprimand was issued to the AML/CTF responsible persons and in two cases responsible persons were dismissed from carrying out the job duties.

The year 2018 was significant with the final stage of the historic change process that was implemented by Latvian banks that specialised in the servicing of foreign customers – 12 banks developed new business models under the supervision of the FCMC. During the reporting year the share of foreign deposits in total deposits decreased by almost half and in December 2018 it was 20.3% (at the end of 2017 – 39.7%). Assessing the turnover of foreign client financial resources, payments in US dollars decreased significantly already in 2016, when the ML/TF risk mitigation measures were tightened. In turn, when comparing the fourth quarter of the reporting year with the respective period of 2015, US dollar payments in Latvian banks had decreased by more than 10 times; therefore, the euro has been strengthening as the dominating payment currency in the financial sector of Latvia.

The aforementioned events have not negatively influenced Latvian domestic deposits that have been increasing over the last few years. In Latvian banks domestic and EU country deposits dominate, reaching 91% of the total deposit amount, 80% are the financial resources of domestic clients, but 11% – resources of EU country clients.

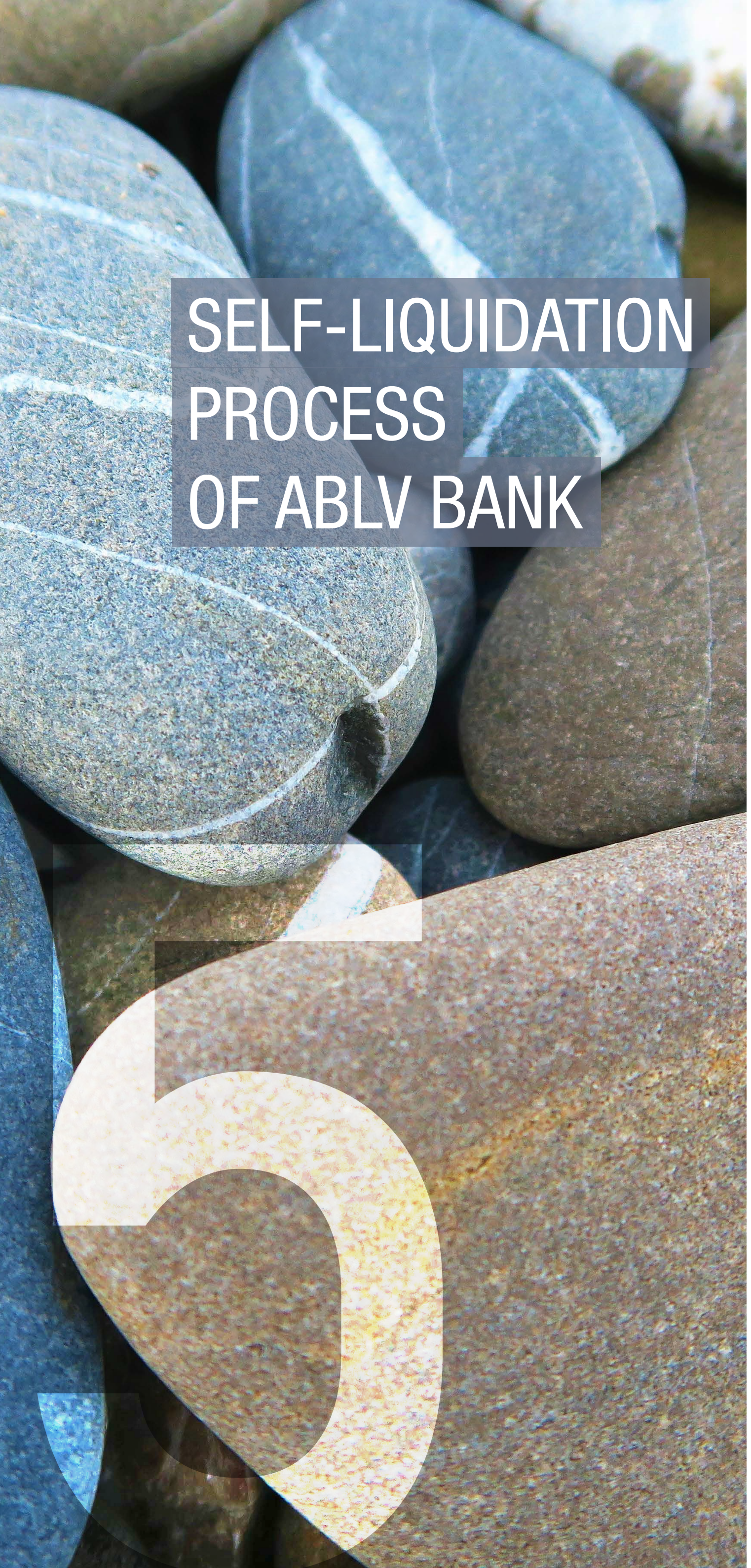
In 2018, in relation to the issues of the prevention of money laundering the FCMC representatives participated in the work of the Committee of Experts on the Evaluation of Anti-Money Laundering Measures Moneyval of the Council of Europe, as well as participated in the execution of the tasks set by the Action Plan for the Prevention of Money Laundering and Terrorist Financing for the Time Period until 31 December 2019 approved by the Cabinet of Ministers. Whereas on 26 April 2018 in Brussels and on 30 August 2018 in Riga the Chairman of the FCMC presented the change management process in the Latvian banking sector to the representatives of the TAX3 Special Committee on Financial Crimes, Tax Evasion and Tax Avoidance of the European Parliament, at the same time highlighting issues about the route of a suspicious money flow in the EU and suggesting an assessment of an initiative about a unified financial intelligence institution in Europe, ensuring further joint control of financial crime risks and their prevention in the European area.

In 2018, work on the development of the FCMC strategy for 2019-2023 was carried out, where five operational priorities were determined: consistent and professional supervision of the financial sector; professional and responsible organisation with effective corporate management and processes; objective, timely and straightforward communication; a favourable business environment for innovative and reliable financial services; an effective crisis management and bank resolution mechanism of the financial sector. In May 2019, the Board of the FCMC approved the strategy.

4 ABBREVIATIONS USED IN THE ANNUAL REPORT

ABLV Bank – ABLV Bank, AS
AIF – alternative investment funds
AIFM – alternative investment fund managers
AML/CTF – anti-money laundering and combating terrorist financing
BRRD – Bank Recovery and Resolution Directive
CCB – counter-cyclical capital buffer
CET1 – common equity Tier 1 capital ratio
CIS – Commonwealth of Independent States
CRR/CRD IV – Capital Requirements Regulation/Capital Requirements Directive
CTPLI – Compulsory Third-party Liability Insurance of the Owners of Motor Vehicles
DGF – Deposit Guarantee Fund
EBA – European Banking Authority
EC – European Commission
ECB – European Central Bank
EEA – European Economic Area
EIOPA – European Insurance and Occupational Pensions Authority
ESMA – European Securities and Markets Authority
ESRB – European Systemic Risk Board
EU – European Union
EY – SIA Ernst & Young Baltic
FPI – Fund for the Protection of the Insured
FCMC – Financial and Capital Market Commission
FIML – Financial Instruments Market Law
FinCEN – United States Department of the Treasury's Financial Crimes Enforcement Network
FinTech – information technology-based financial services innovations
FSF – financial stability fee
GC – guaranteed compensation
ICAAP – Internal Capital Adequacy Assessment Process
IFRS – International Financial Reporting Standards
ILAAP – Internal Liquidity Adequacy Assessment Process
InsurTech – information technology based insurance services innovations
IT – information technology
LCR – Liquidity Cover Ratio
LPSEM – Law on Payment Services and Electronic Money
LR – The Republic of Latvia
MiFID II – Financial Instruments Market Directive
MiFIR – Financial Instruments Market Regulation
MLTF – money laundering and terrorism financing
NPL – non-performing loans
O-SII – other systemically important institution
OECD – Organisation for Economic Cooperation and Development
PSD2 – European Second Payment Services Directive
ROE – return on equity
SFPS – state-funded pension scheme
SPA – staff performance appraisals
SREP – Supervisory Review and Evaluation Process
SRF – Single Resolution Fund
SRB – Single Resolution Board
SSM – Single Supervisory Mechanism
TCR – total capital ratio
USA – the United States of America


FCMC
ACTIVITIES
IN
2018



5 SELF-LIQUIDATION PROCESS OF ABLV BANK

The licence of ABLV Bank, AS (until 12 June 2018; as of 13 June 2018 – ABLV Bank, AS in liquidation) was issued on 9 September 1993. ABLV Bank was the third largest bank according to the amount of assets in Latvia and the largest private bank with domestic capital.

On 13 February 2018, the US FinCEN, taking into account that the Latvian commercial bank ABLV Bank raised concerns of money laundering, published a proposal to apply to it the special measures of Section 311 of the USA Patriot Act. After publishing of the FinCEN proposal an increased activity by ABLV Bank clients was detected in the withdrawal of deposits, and as a result, on 18 February 2018 the Board of the FCMC, considering the conditions created by the FinCEN report and based on the instruction by the ECB under whose direct supervision was ABLV Bank, took a decision according to which disbursement restrictions were determined for ABLV Bank.

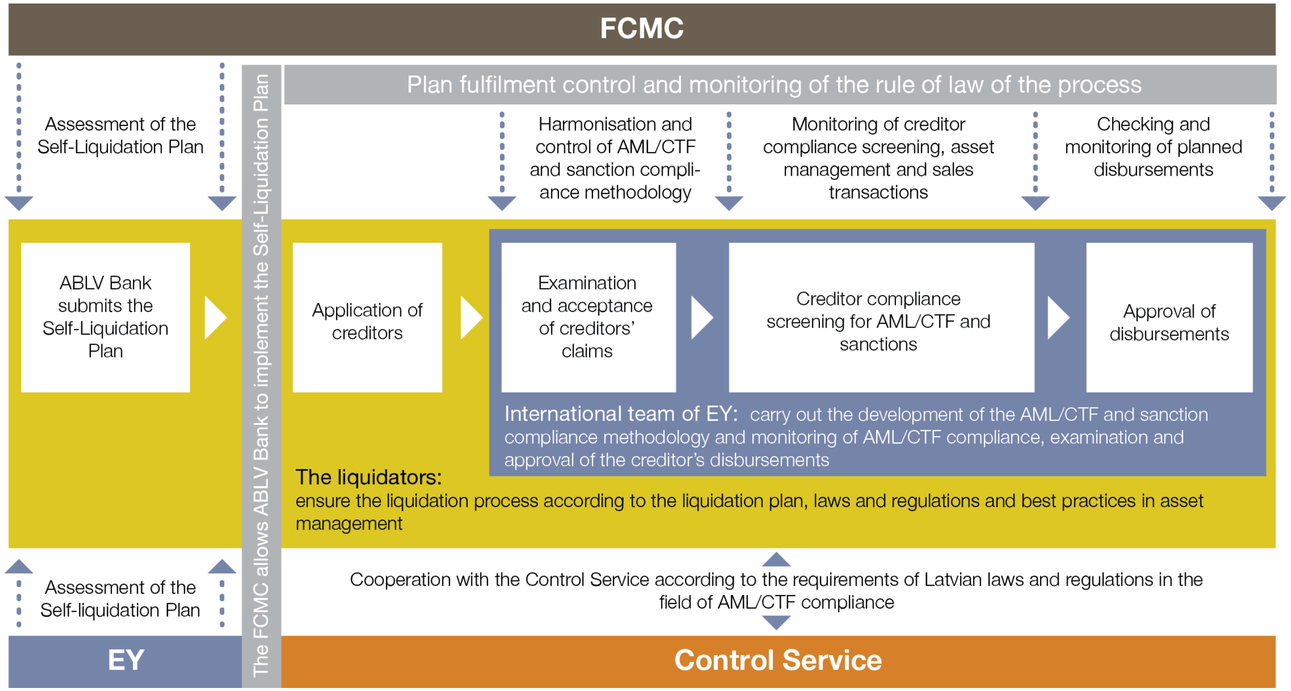
As the ECB had not given instructions to remove the aforementioned disbursement restrictions by 23 February 2018, the Board of the FCMC, in accordance with the Deposit Guarantee Law, on 23 February 2018 took a decision that the deposit inaccessibility had occurred to ABLV Bank, but on 27 February 2018 a decision was taken on the disbursement of guaranteed compensation to the ABLV Bank depositors.

On 24 February 2018, the ECB took the decision to recognize ABLV Bank “failing or likely to fail”, which actually meant termination of the credit institution’s activity. To protect the interests of the clients and creditors and to ensure the protection of the assets of the credit institution, the shareholders of ABLV Bank used the rights determined in the Credit Institution Law and on 26 February 2018 took a decision on self-liquidation of the credit institution, on 5 March 2018 submitting the draft Self-Liquidation plan to the FCMC for approval (hereinafter – the Self-liquidation Plan).

On 12 June 2018, after the evaluation of the Self-Liquidation Plan the Board of the FCMC permitted ABLV Bank to start self-liquidation. The FCMC reviewed the Self-Liquidation Plan by assessing the ability of ABLV Bank to fulfil its obligations against the creditors within a specified deadline and in full amount. Several institutions supervising ABLV Bank were involved in the assessment, along with an independent commercial company of certified auditors that carried out the quality review of ABLV Bank assets and the examination of self-liquidation assumptions. Having taken the decision, the FCMC concluded that ABLV Bank had a sufficient amount of assets to satisfy the claims of all creditors, and was allowed to start the self-liquidation process under strict control by the FCMC, with the FCMC continuing to supervise the work of ABLV Bank liquidators until the end of the self-liquidation process. Considering the possible AML/CTF and international sanction risks, the Self-Liquidation Plan approved by the FCMC foresees that during the self-liquidation period ABLV Bank ensures fulfilment of the requirements of laws and regulations concerning AML/CTF and international sanctions applicable to credit institutions. According to the approved Self-Liquidation Plan under the management of EY contracted by ABLV Bank, the methodology for the compliance and control of AML/CTF and international sanctions was developed and applied (hereinafter – the Methodology) to prevent possible money laundering and the violation or circumvention of sanction requirements during the creditor claim disbursement process.

Thus a voluntary bank liquidation process controlled by the FCMC (see the scheme) is a solution that ensures the broadest involvement of the FCMC and implementation of the control over the further liquidation process. Taking into account the aforementioned and in order to ensure the realisation of the FCMC rights (to control the activity of the liquidator) laid down in Paragraph four of Section

ABLV Bank liquidation scheme



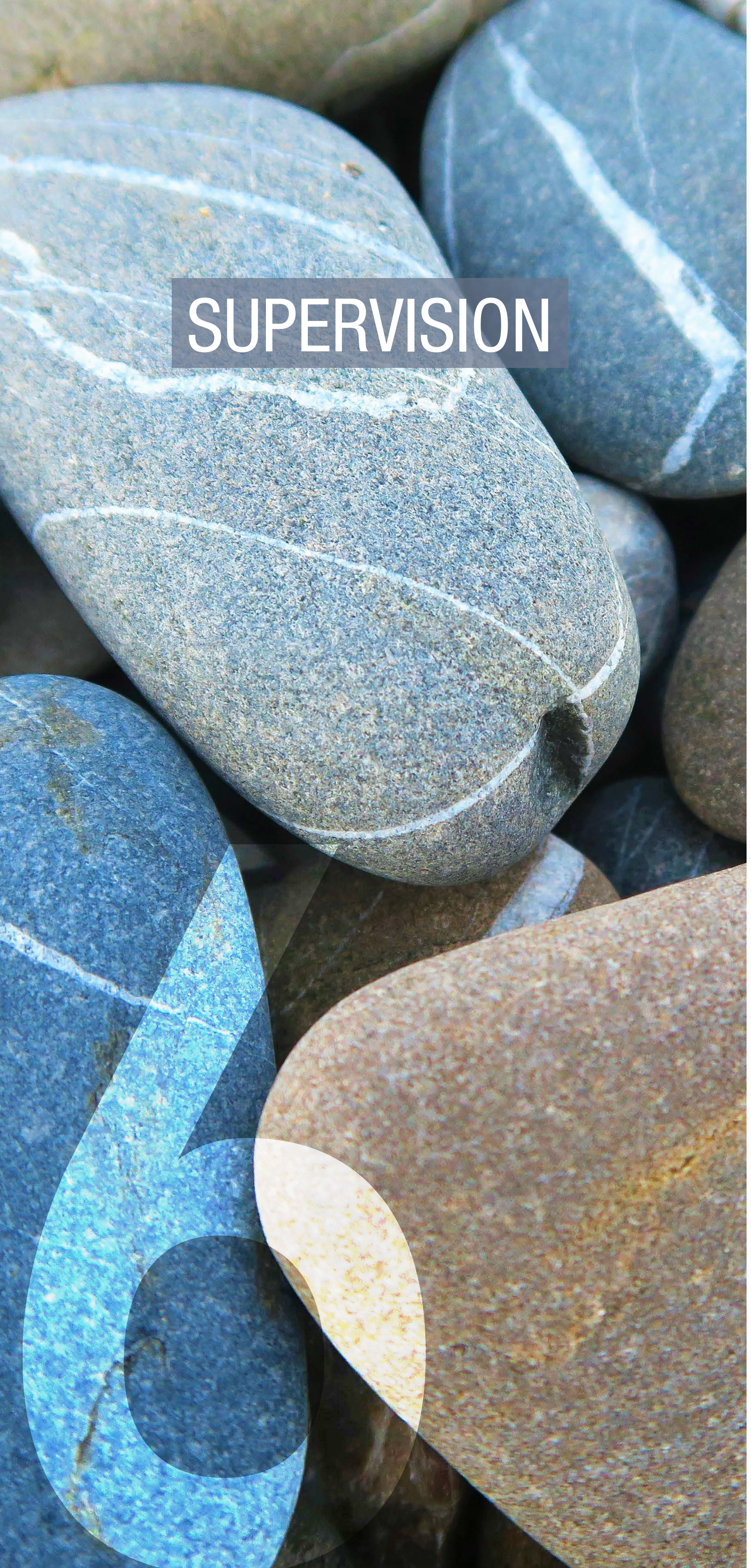
132 of the Credit Institution Law, including the assurance of the control of the approved plan, supervision of the rule of law of the liquidation process and ABLV Bank activities in the management and retention of assets, as well as supervision of the fulfilment of the requirements of AML/CTF and international sanctions, with the FCMC order of 2 July 2018 a group of persons was authorised to supervise the activities of the liquidators of ABLV Bank in liquidation and the self-liquidation process (hereinafter – the Group of Authorised Persons).

On 1 August 2018, EY submitted the first draft of the Methodology to the FCMC. Henceforth intensive work took place within the scope of which the FCMC and its contracted external consultant, as well as the Office for the Prevention of Laundering of Proceeds Derived from Criminal Activity assessed the Methodology developed by EY. Taking into account the objections, comments and proposals expressed during the assessment process, EY made significant adjustments and corrections to the originally submitted version of the Methodology. After harmonisation of the final version of the Methodology with the Office for Prevention of Laundering of Proceeds Derived from Criminal Activity on 6 March 2019 at the extraordinary meeting, the Board of the FCMC took a decision to harmonise the Methodology submitted by the liquidators of ABLV Bank in liquidation.

Further on, the Group of Authorised Persons will carry out on-site supervision in ABLV Bank during the Methodology introduction phase to make sure that the introduction and application thereof are carried out according to the Methodology. The following procedure for creditor claim satisfaction will take place under strict supervision of the FCMC – based on the results of the independent examination carried out by EY, the liquidators of ABLV Bank will develop the disbursement list with those creditors who have undergone the compliance examinations and comply with the requirements defined in the Methodology. This list will be submitted for approval to the FCMC, which will supervise the disbursement process and, if it is necessary, will carry out re-examination of creditors' compliance with the Methodology requirements.

Concurrently with the whole liquidation process, the FCMC will also continue to supervise the activities of the liquidator in asset management and maintenance to protect the interests of the creditors of ABLV Bank. For this purpose, the liquidators provide regular reports containing information on the updated financial indicators of ABLV Bank, the liquidation progress and the planned liquidation measures, as well as a financial forecast for the further self-liquidation period up to the end of 2022 is provided, including the information on the sufficiency of assets for the fulfilment of creditors' claims at the planned completion of self-liquidation.

ABLV Bank had 22,830 clients who are entitled to receive guaranteed compensation in the amount up to EUR 100,000. When disbursing the guaranteed compensation it will be ensured that the deposits of 88% of ABLV Bank clients will be disbursed in full overall. EUR 480 million is necessary for the pay-out of compensation to the clients of ABLV Bank, which ABLV Bank has transmitted to the account of the FCMC where the funds of the DGF are kept.



SUPERVISION

SUPERVISORY PRINCIPLES

The FCMC regulates and oversees the sector of the Latvian commercial banks in close cooperation with the ECB within the scope of the SSM and with the European supervisory authorities, as well as pursuant to the best international credit institution supervisory practices and operational frameworks.

The main principle of supervision is to identify, as soon as practicable, any problems in the financial market or in the activity of an individual market participant in order to immediately issue the supervisor's opinion and recommendations or to require the elimination and minimisation of the problems.

Supervision is one of the key pillars of a sound financial system, which complements the self-regulation of financial markets and the internal control mechanisms of each financial institution. The main objective of supervision is to ensure that each supervised institution is managed professionally and prudently in accordance with the nature of its activities and exposure to risks.

In order to promote the protection of the interests of investors, depositors and the insured, as well as the stability of the financial and capital markets, the FCMC has been undertaking continuous and comprehensive supervision over market participants by:

- determining the priorities of the supervision of each financial sector for the coming year, based on the risk assessment and trends in the financial market;

- developing supervisory programmes for each sector as well as for each market participant, based on the defined priorities;

- maintaining a constant dialogue with market participants and professional associations regarding the new requirements, sectoral trends, and the risks and problematic issues pertaining thereto;

- ensuring that new market participants with a sound capital base and clear and viable strategy enter the market;

- carrying out off-site analysis of the indicators characterising the activities of market participants, risks and risk management systems, continuously focussing on the qualitative and quantitative changes of the financial indicators as well as compliance with regulatory requirements and the effectiveness of corporate governance;

- ensuring, within the scope of its competence, the disclosure of true and fair information about the activity of market participants;

- carrying out on-site inspections and horizontal off-site inspections;

- assessing the quality of financial services and ensuring consumer protection within the scope of its competence;

- in cases of non-compliance with regulatory requirements, imposing preventive and corrective measures on the market participants in a timely manner.

The FCMC has been continuously improving the methods applied in the supervision of all market participants.

BANKING SECTOR

In 2018, the FCMC continued to consolidate the framework of intensive supervision, the purpose of which is to take risk-based and result-orientated supervisory measures and enable the FCMC to get interfered in the activities of the banks and take the necessary measures to resolve potential and existing problems or reduce losses in a timely manner.

At the beginning of 2018, based on the assessment of the operational risks of credit institutions and of the trends of the financial system, the FCMC set the supervisory priorities.

Credit institution supervisory priorities set in 2018:

- assessment of the strategy, business model and earning capacity of credit institutions with the focus on the reduction of AML/CTF risk and balancing of sustainability and earning capacity;

- strengthening the compliance and risk management functions, focussing on the process of the performance and effectiveness of the stress test of the bank, enhancement and practical application of the recovery activity plans, the reporting quality, as well as the elimination of deficiencies discovered during horizontal inspections;

- credit risk and assessment of adequacy of provisions, focussing on problematic loans and the recovery process, elimination of the deficiencies discovered during horizontal inspections. In parallel, the supervisors focussed on the introduction of IFRS 9 and the impact thereof.

Based on the priorities, the minimum amount of supervisory measures was identified and, taking into account the existing resources, the supervisory measure plan was drawn up for 2018, which comprised both on-site and off-site supervisory measures.

Supervision of banks in 2018 was constantly based on related methods — the off-site monitoring of the performance of banks, on the basis of analysis of their financial statements and other operational information at the disposal of the FCMC, as well as on-site inspections.

A number of off-site measures were taken for the assessment of the **business model and earning capacity** in accordance with the approved plan of supervisory measures, inter alia, the reports submitted by the banks, performance indicators and other information at the disposal of the supervisor was analysed, as well as the material risks inherent to the banking business were assessed. Within the scope of assessment of the business model and earning capacity, indicators such as return on equity (ROA), cost-income ratio, income stability, changes in number of payments and number of customers, interest and tariff policy, etc. were assessed. In addition to the usual risk assessment of the business model, in 2018 a special emphasis was put on the change of the banking business model, which, following the directions by the Latvian policy makers (Prime Minister, the Ministry of Finance), was implemented under reinforced supervision by the FCMC (additional information is reflected in the section on supervisory inspections and assessment process).

In 2018, a special emphasis was put on the change of the banking business model, which, following the directions by the Latvian policy makers (Prime Minister, the Ministry of Finance), was implemented under reinforced supervision by the FCMC.

The focus of **strengthening the compliance and risk management functions** was on the reinforcement of the internal capital and liquidity adequacy assessment process in the banks, enhancement and practical application of recovery plans. The work was continued on the mechanism for the quality control of the reports developed by banks, as well as on the elimination of the drawbacks discovered during the previous horizontal inspections in banks.

In the field of **credit risk and assessment of adequacy of provisions**, the main focus was on the work of banks with problematic loans and the process of recovery thereof, elimination of the deficiencies discovered by the FCMC in previous horizontal inspections, as well as on the introduction of IFRS 9 and the impact thereof on bank performance and regulatory indicators.

Supervisory Review and Evaluation Process

Risk-based supervision is still one of the key principles of supervision. Under this principle, the FCMC, using information disclosed in the reports received from banks, as well as other information available thereto, is constantly assessing the performance of banks, the level of risks and the quality of their management; and based on the results of the monitoring of these risks, plans the necessary supervisory measures, including on-site inspections.

Requirement to change the banking business model

At the basis of the business model change for the banks whose main activities were servicing of foreigners, were supervisory measures already carried out in 2015-2016 with the main attention pointed towards the requirement:

- to focus more on the termination of business with high-risk clients;

- to ensure that banking business models are viable and sustainable;

- for banks to develop an AML/CTF strategy, ensuring its integration in the banking business strategy.

In February 2018, the FCMC continued more intensive discussions with banks regarding the more rapid change of the business model, following the directions by the Latvian financial policy makers (Prime Minister, the Ministry of Finance).

As banking business models change, a range of elements related to the banking activities also change, including products and services offered by banks, target markets and clients. Such changes are comprehensive and also affect the balance structure of banks and the bank risk profile, etc. Taking into account the aforementioned, the FCMC, in addition to business model analysis, carried out a comprehensive assessment of all the existing and potential risks concerning the banking operations and those related to the banking operations.

In 2018, the SREP carried out by the FCMC was improved by introducing supervisory dialogues on the SREP results according to the SREP guidelines developed by the EBA, as well as the ECB guidelines regarding the SREP of less important banks.

In 2018, a significant focus of the SREP was pointed towards the revised banking business models and assessment thereof, paying special attention to the profitability, viability and sustainability of banks, as well as the risks connected with the change of the business model.

Risk assessment, within the scope of the SREP, is being carried out biannually, and it takes into account both the risk level characterising quantitative indices and their thresholds in accordance with the ECB methodology[1], as well as information on risk management arising out of the on-site inspections, thematic and horizontal inspections, information at the disposal of the FCMC on the observance of the regulatory requirements in the credit institutions, detected internal control system flaws, quality of the capital and liquidity adequacy assessment processes and the recovery plan assessment.

In 2018, the FCMC carried out intensive off-site monitoring of banking activities, which was based on ICAAP and ILAAP reports, the analysis of the regular reports submitted by banks, as well as the analysis of the following additional operative statements, information and reports on the banking activities:

- a daily report about the dynamics of deposits;

- reports about liabilities to related-party financial institutions;

- minutes of the meetings of bank credit committees, of the management board and supervisory board as well as internal audit reports of banks on the reviews;

- reports on the results of risks and stress tests.

Banks were invited to present part of the above-mentioned operative information, thus promoting a mutual dialogue between the FCMC and the banks.

Risk assessment of the important banks being under direct supervision of the ECB is carried out annually, by means of the methodology prescribed by the ECB.

Risk assessment, within the scope of the SREP, is carried out in the rating scale from “1” to “4”, and, in 2018, the following risk ratings were assigned to banks in Latvia:

Risk assessment	1.0 – 1.7 (low risk)	1.8 – 2.5 (moderately low risk)	2.6 – 3.3 (moderately high risk)	3.4 – 4.0 (high risk)
Number of banks[2]	0	6	6	3

[1] Available only to the supervisory authorities within the scope of the SSM.

[2] Including the banks under the direct supervision of the ECB.

The planning of the supervision of a bank is performed based on the risk rating assigned to it – the required supervisory measures applied to a bank that has been assigned the lowest rating (the institution's activities have a low inherent risk and its risk management is sufficient) are minimal, whereas an institution with the highest risk rating (the institution's activities have a high inherent risk and its risk management is weak) needs continuous and enhanced supervision.

The SREP results were taken into account when determining own fund requirements for covering the risks inherent to the banking activity and potential risks, and special liquidity requirements, as well as by applying other supervisory measures (for example, by imposing an obligation to submit reports more frequently, to develop a capital strengthening plan, to develop measures for the reduction of non-performing assets, to improve the internal control system, etc.).

Sanctions and corrective measures

Within the scope of implementation of the supervision of the banking operations, in 2018 the FCMC imposed a fine on one bank for the violation of the requirements of the Credit Institution Law. The FCMC also took corrective measures, setting additional requirements to eight banks in the field of credit risk.

Group supervision

In 2018, the FCMC cooperated with the supervisory authorities of the credit institutions of the Member States, which pursuant to the requirements of the laws and regulations implement the supervision of groups of credit institutions. In 2018, FCMC staff took part in the work of the four supervisory colleges of the EU Member States' credit institutions, including the chairing of one supervisory college in the capacity of the responsible supervisory authority.

In 2018, the most significant directions in the agenda of the colleges comprised the coordination of supervisory measures, the assessment of the evaluation process of internal capital and liquidity adequacy processes by banks and the risk profile at the group level, as well as the assessment of the recovery activity plans developed by banks.

On-site inspections in credit institutions

During the reporting year, the FCMC carried out four on-site inspections in banks, paying particular attention to the lending process, as well as risk management functions – management of credit risk, operational risk, liquidity risk, market risk, operational compliance risk, strategy, and business risk. The deficiencies and irregularities identified during inspections were discussed with the bank management and action plans were coordinated to implement the necessary improvements. Follow-up monitoring was carried out within the scope of off-site supervision by controlling the course of implementation of the action plan in the field of the prevention of deficiencies.

The representatives of the Commission also participated in the controls initiated by the ECB that were carried out in systemically important credit institutions aiming to assess the quality and compliance of internal models for the calculation of credit risk capital requirements in the banks, as well as the internal governance issues.

Capital adequacy

The level of the capitalisation of banks remained high at the end of 2018. The quality of the capital of the banking sector is ensured by the key element of the own funds of banks, i.e. CET1 capital, which currently equals Tier 1 capital in the case of Latvian banks.

In 2018, seven banks used the possibility to consolidate their capital base in the sum total of EUR 35 million: six banks decided not to divide the audited profit of 2017 or a part of it and leave it at the disposal of the bank, while one bank increased the paid-up share capital by EUR 2.13 million. Three banks disbursed the dividend from part of the audited profit of 2017, whereas one bank disbursed all the audited profit of the previous year.

Within the scope of the supervisory process, the FCMC paid attention to and assessed the adequacy of provisions made by the banks for expected losses. A positive difference between the volume of expected losses and the provisions made under the requirements of the accounting standards was taken into account when assessing the capital adequacy ratio of banks.

The banks have assessed their internal capital adequacy ratio each year to ascertain that the capital of the bank, in terms of the amount, elements and the breakdown thereof, is adequate for covering the risks inherent in the current and planned activities of the bank, as well as for covering potential risks, and that a sufficient capital buffer is ensured in the case of the occurrence of potential significantly adverse circumstances affecting their operations. The results of the inspections carried out by the FCMC revealed the areas, in which the banks needed improvements.

During the assessment of bank capital adequacy ratios, the FCMC paid particular attention to whether the capital adequacy ratio was consistent with the future operational strategy of the bank and the size of the risks inherent to the bank's planned operations, as well as to the methods employed for managing these risks.

Within the scope of the SREP, in 2018, the FCMC evaluated the level and management of banking risks mentioned in Article 92 of Regulation No. 575/2013 (Tier 1 risks), and other risks inherent to the activities of the credit institutions and probable risks (Tier 2 risks) and in accordance with the rights provided for by the Credit Institution Law set the requirements to all banks to maintain the highest own funds level for covering such risks inherent to the activities of the credit institutions and probable risks, which are not covered by the own funds requirements set by Regulation No. 575/2013.

Liquidity

Sufficient liquidity of the credit institutions ensures the ability to withstand the potential reduction of the deposit base under the influence of external macroeconomic environment risks, and, for the purposes of ensuring adequate liquidity, the FCMC is entitled to set special liquidity requirements to the credit institutions. The FCMC assesses the risks inherent to the activities of the credit institution and probable risks, taking into account the business model thereof, risk management principles and possible systemic liquidity risk that might endanger the stability of the financial market of Latvia.

Also in 2018, the FCMC evaluated whether the strategy, procedures and measures taken by the credit institutions ensure sufficient risk management, whether the amount of liquidity reserves of the credit institutions is sufficient for covering the liquidity and financing risks inherent to its activities and corresponds to the business models. The FCMC evaluated the reports of the credit institutions regarding the process of the liquidity adequacy assessment, and, in 2018, prescribed the special liquidity requirement to 12 banks, the activities whereof were mainly focussed on servicing foreign customers.

Risk management function

In providing financial services, banks need to ensure not only the effectiveness of every business unit or activity type but also establish and efficiently implement the overall risk management function, which is important for their activities. In 2018, in carrying out the inspections of banking activities, the FCMC continued to focus closely on the quality of management of each key risk. The size of the particular risk and the effect of changes on the bank's overall operations, as well as the effectiveness of the internal control system and of the efficiency of the activities of bank management in identifying, measuring and managing each relevant risk were considered in the assessment of each risk management function. Particular attention was paid to establishing whether, in managing key risks, banks were using tools such as stress tests and scenario analysis, and the quality of those stress tests and selected scenarios, as well as their appropriateness for the nature of activity of each bank were assessed. If necessary, the banks were requested to carry out improvements.

Single Supervisory Mechanism

4 November 2018 marked four years since the SSM had been established. It has three key objectives:

- to ensure the security and stability of the European banking system;
- to improve financial integration and stability;
- to ensure coordinated supervision.

Together with the ECB, 26 competent authorities operated within the scope of the SSM (19 national competent authorities and seven national banks) from 19 EU Member States. Overall about 6,000 employees are involved in supervision. In 2018, under direct supervision of the ECB there were 118 important banks, whereas under the supervision of national competent institutions there were about 4,000 less important banks.

In 2018, three Latvian banks – Swedbank, SEB banka and ABLV Bank (until withdrawal of the licence on 12 July 2018) were supervised by the ECB, and from 10 February 2018, following the merger of DNB banka and Nordea Bank Branch in Latvia, Luminor Bank also became subject to direct ECB supervision. These banks are supervised, with ECB and FCMC staff participating in the joint supervisory work teams, which form the basis of the everyday supervision of important banks.

The FCMC continued to supervise less important banks and, at the same time, in cooperation with the ECB and other national competent authorities, to enhance and adjust the single guidance and guidelines for the supervision of such banks. The FCMC took active part in the processes managed by the ECB, namely, the analysis of earning capacity of banks, the assessment of IFRS 9, addressing the NPL issue, developing respective guidelines for banks. Various measures were taken to improve the solvency of the Eurozone banking sector, as well as the FCMC took active part in the development of common supervisory standards by improving one of the key banking supervisory tools – SREP.

Due to the Chairman of the FCMC being a member of the Supervisory Board of the ECB, the FCMC was also involved in the process of adopting SSM decisions, adopting the decisions on both all of the significant banks under direct supervision of the SSM, and regarding the methodological issues determining the procedure for the implementation of the banking supervision process in the Eurozone as a whole. FCMC experts assessed and provided their view on the issues to be reviewed at the Board meetings as well as on the documents examined under written proceedings.

In line with the operational principles of the SSM, providing for the involvement of all Member States in the processes of planning and implementation of the supervision, FCMC experts constantly took part in the committees and work groups set up by the ECB, contributing to the development and enhancement of the ECB's single supervision methodology, as well as further coordination of the statutory regulation within the framework of the European Banking Union.

Banking sector performance in 2018

At the end of 2018, 15 banks and five branches of banks from EU Member States were operating in the Republic of Latvia. During the reporting year, one licence for a credit institution's operations was withdrawn – in February 2018 the FinCEN published a report[3] about ABLV Bank followed by the operation restrictions of this bank[4] and the ECB decision[5] on the withdrawal of the banking licence. During the reporting year, two bank reorganisation processes were implemented. In the middle of 2018, AS Citadele banka took the final decision to change the legal status of AB Citadele banka (Lithuania) from the subsidiary to the branch, thus improving the efficiency of the banking group performance and developing the services of Citadele banka for clients throughout the Baltic states. Thereby, as of 2019, AS Citadele banka has a branch not only in Estonia, but also in Lithuania. In the reporting year, the final stage of the merger project of DNB Bank ASA and Nordea Bank AB, implemented in the Baltic states in autumn of 2017, was continued, resulting in the united bank Luminor Bank AB in Latvia and Lithuania, as of 2019, continuing to operate as branches of Estonian Luminor Bank AS. In autumn of the reporting year, the change of name for one bank was registered in the Commercial Register of the Republic of Latvia – AS Norvik Banka, as of 9 November 2018, is operating in Latvia under the name of AS PNB Banka. As of 4 March 2019, the direct supervision of AS PNB Banka from the FCMC has been taken over by the ECB, classifying it as a significant bank. Further on, within the SSM framework of the European Bank Union under the direct supervision of the ECB there will be three commercial banks (AS Swedbank, AS SEB banka and AS PNB Banka), which constitute about 45% of the total assets of the banking sector.

Banking sector performance indicators[6]

The aforementioned structural changes and the measures implemented to reduce reputational risk, by banks refusing business with high risk foreign clients, determined the direction towards further narrowing of the banking sector – the amount of non-bank deposits and thereby also the amount of the banking sector assets decreased by approximately 20% over the reporting year. In order to cover the drop in the foreign deposit balance, banks mainly decreased investments in liquid assets – both investments in securities (by EUR 1.6 billion or 23.5%) and cash balances in the central bank and other credit institutions (by EUR 1.6 billion or 20.9%). Therefore, the total amount of the banking sector assets decreased by EUR 2.1 billion or 8.5% during the year[7].

Liquidity of banks. Despite a significant decrease in foreign deposits, liquid assets were in sufficient amount to cover deposit outflow and still maintain a high level of the EU determined harmonised LCR binding for banks. At the end of the reporting year, the average size of the LCR of the banking sector amounted to 266% (for individual banks it ranged from 142% to 1,290%), thus exceeding the minimum requirement (as of 1 January 2018 the minimum requirement of the LCR is determined in the amount of 100%) by almost three times. Historically for Group 2 banks[8] by attracting more foreign depositors and providing them the services mainly connected with settlements, a higher level of liquidity level has been also maintained; however, with foreign client's deposits having dropped significantly, the LCR decreased insignificantly, remaining at a very high level.

Capital adequacy[9]. As a result of the asset decrease, the total amount of the risk-weighted assets of the banks reduced in the reporting year and it had a positive impact on the capital ratios of the banking sector, the TCR

[3] On 13 February 2018, the USA FinCEN published a proposal to recognise ABLV Bank as an institution creating significant risks of money laundering and to determine restrictions for transactions with this bank.

[4] On 24 February 2018, with the decision of the ECB, ABLV Bank was recognised as a financial institution failing or likely to fail. On 12 June 2018, the FCMC took a decision to allow ABLV Bank to start the self-liquidation process applied by the shareholders of ABLV Bank on 26 February 2018.

[5] On 11 July 2018, the ECB took a decision on the withdrawal of the licence of ABLV Bank.

[6] As of 2018, in the publications by the FCMC the FINREP and COREP data provided by the banking sector are mainly used – the consolidated data of the banks under the consolidated supervision (i.e. the data on banks and their financial subsidiaries), as well as the data on other banks and foreign bank branches on an individual level.

[7] Excluding the impact of the structural changes of the banking sector.

[8] Hereinafter Group 2 banks – the banks whose operations are focused on the servicing of foreign clients, Group 1 banks – the banks whose operations are focused on the servicing of domestic clients.

[9] Excluding the impact of the structural changes of the banking sector.

increasing from 20.8% to 22.3%, but CET1 – from 19% to 19.7%. The total amount of the risk-weighted assets decreased by EUR 643 million or 5%, which was fully determined by the decrease in the risk-weighted assets of the banks focused on the servicing of foreign customers (by EUR 767 million or 18.4%), reflecting a significant improvement of the capital ratios of these banks. The capital ratios of the banks focused on the servicing of domestic customers remained practically unchanged. Overall the capital ratios of the Latvian banking sector were still higher than in the EU on average (TCR – 19.0%, CET1 – 14.7%)[10], ensuring the buffer for the coverage of possible losses at a sufficient level.

Figure 1 Common equity Tier 1 capital ratio (CET1), %

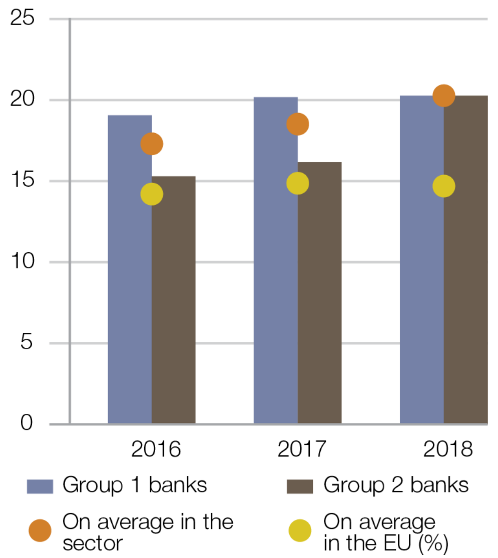
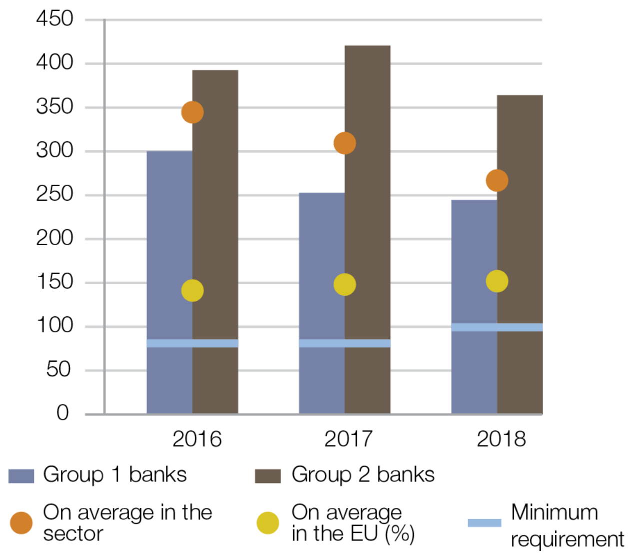


Figure 2 Liquidity coverage ratio (LCR), %



Earning capacity. Despite a rapid drop in the amount of business the earning capacity development trend was positive in the banking sector in 2018. The earnings of the banking sector[11] amounted to EUR 274 million; moreover, the performance of 12 banks and three branches of foreign banks (the market share whereof made up 94% of the total assets of the banking sector) involved a profit. As the earning capacity of the banking sector improved, at the end of the reporting period the ROE reached 9.3% (at the end of 2017 – 7.6%), thus exceeding the average EU level (6.5%); in turn, the ROE of individual banks ranged from -37.6% to 19.3%.

Simultaneously, in the development of the earning capacity the differences increased among the banks that are focused on the servicing of domestic customers, and the banks whose operations are focused on the servicing of foreign customers. The earning capacity ratios of the banks focused on the servicing of domestic customers remained at a high level in the reporting year reflecting the overall favourable domestic economic environment. The banking profit of this group reached EUR 250 million, i.e. 86% of the total banking sector profit was concentrated in this banking group. In turn, the ROE grew from 8.8% to 12% respectively, exceeding both the average ratios of the Latvian banking sector and those of the EU.

[10] Hereinafter the EU data source: *EBA Risk Dashboard 2018 Q4.*

[11] Unaudited.

In turn, the implemented risk reduction measures and the decrease of business amount determined a gradual reduction of the operating income of the banks focused on the servicing of foreign customers (by 19.6%)[12]. Although the drop in operating income was fully offset by the income from the reduction in provisions, as well as by the optimisation of administrative costs (by 10.1%)[12], in determining the growth of the total profits and the improvement of the ROE of these banks, overall the impact of these factors on further profit growth is not sustainable.

Figure 3 Return on equity ratio (ROE), %

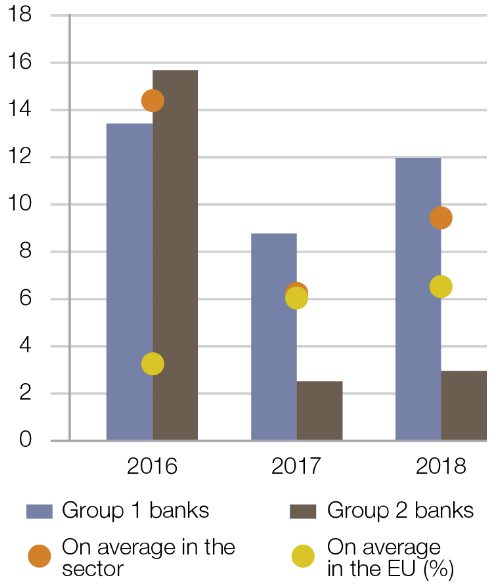
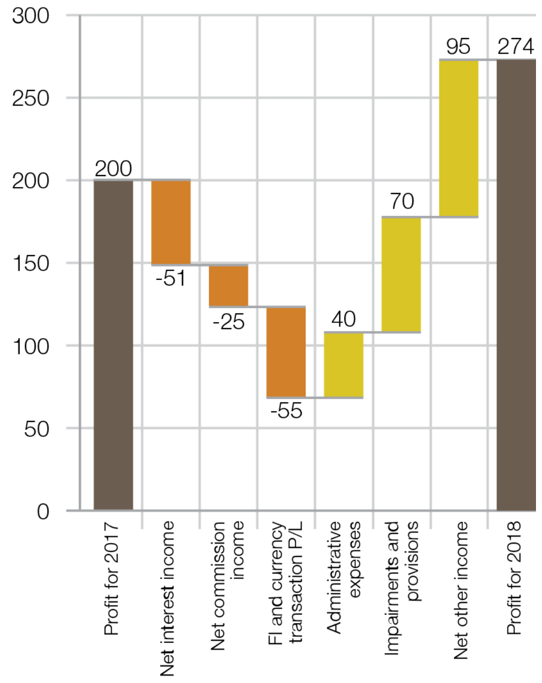


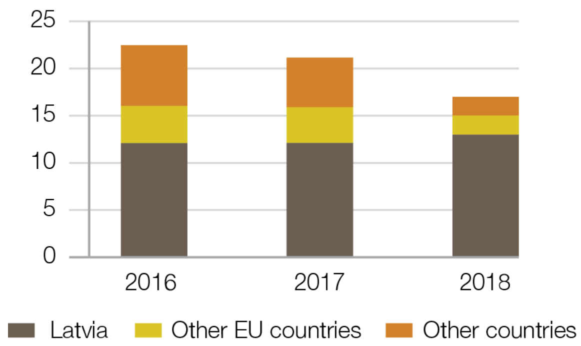
Figure 4 Changes in profit, EUR million



[12] Excluding the impact of the structural changes of the banking sector.

Amount of deposits[12]. During the reporting year the total amount of non-bank client deposits decreased by EUR 1.3 billion or 7.2%. The drop in foreign client deposits in the Latvian banking sector had already been observed since 2015; however, as a result of the measures implemented by banks during the reporting year the process increased significantly and overall during the year the balance of foreign client deposits decreased by 37.4% or EUR 2.4 billion (including from EU countries – by EUR 0.7 billion, but from non-EU countries – by EUR 1.7 billion). The drop in foreign deposits was partly compensated by the stable increase of domestic client deposits (during the year by EUR 869 million or 7.2%), which was observed along with the favourable economic development of Latvia. In the second half of the year, the amount of foreign client deposits stabilised as well, mainly as a result of the increase in the EU country client deposits, while the deposits from clients from other countries continued to decline. Thus, a change in the strategies implemented by individual banks was observed, foreseeing further progress towards the attraction of deposits from EU country clients.

Figure 5
Dynamics of deposits with non-banks, in billion EUR

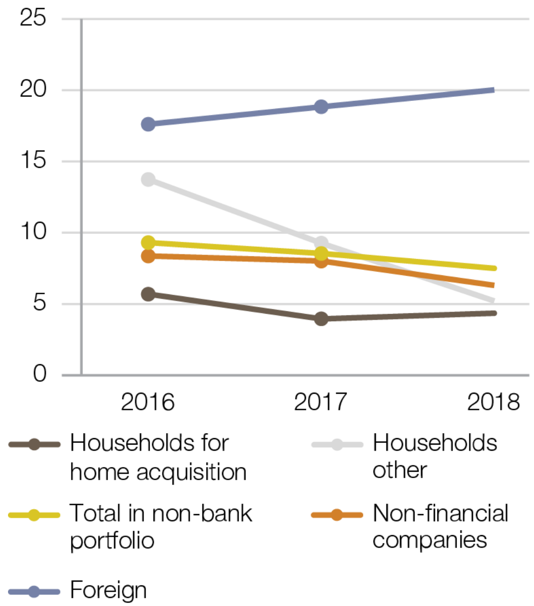


As a result of opposing trends of domestic and foreign deposits, the geographic structure of deposits (according to the client's country of registration) also changed significantly, and the share of domestic deposits at the end of the reporting year reached 76.4%, EU countries – 13.7%, other countries, in turn – 9.9% (at the end of 2017 57.3%, 17.9% and 24.8%, respectively).

Loan portfolio. During the reporting year, a stable growth of the loan portfolio of domestic non-bank clients was observed[13] – this was determined not only by non-financial corporations (by 3%), but also by the increase in the lending amount to households (by 1.5%). More active lending was observed in the construction, energy and wholesale sectors, as well as in consumer and housing loan segments, where the state support programme for house purchase continued to play a major role. In turn, the balance of the loan portfolio of foreign non-bank clients dropped by 5.1% over the year, thus reducing the annual growth rate of the total non-bank loan portfolio to 1.8%.

Quality of the loan portfolio. The NPL[14] ratio in the non-bank credit portfolio decreased overall, reaching 7.5% at the end of the year. Improvement in the quality of the credit portfolio was observed in both the domestic non-financial corporation segment and the household segment, reaching 6.3% in the domestic non-financial corporation loan portfolio and 4.5% in the household loan portfolio at the end of the year (8.0% and 4.9% at the end of 2017, respectively). In turn, in the segment of foreign clients, the credit quality indicators slightly deteriorated (mainly due to the drop of this portfolio), the NLP ratio reaching 20% at the end of the year (18.8% at the end of 2017).

Figure 6
NPL, % of the respective portfolio

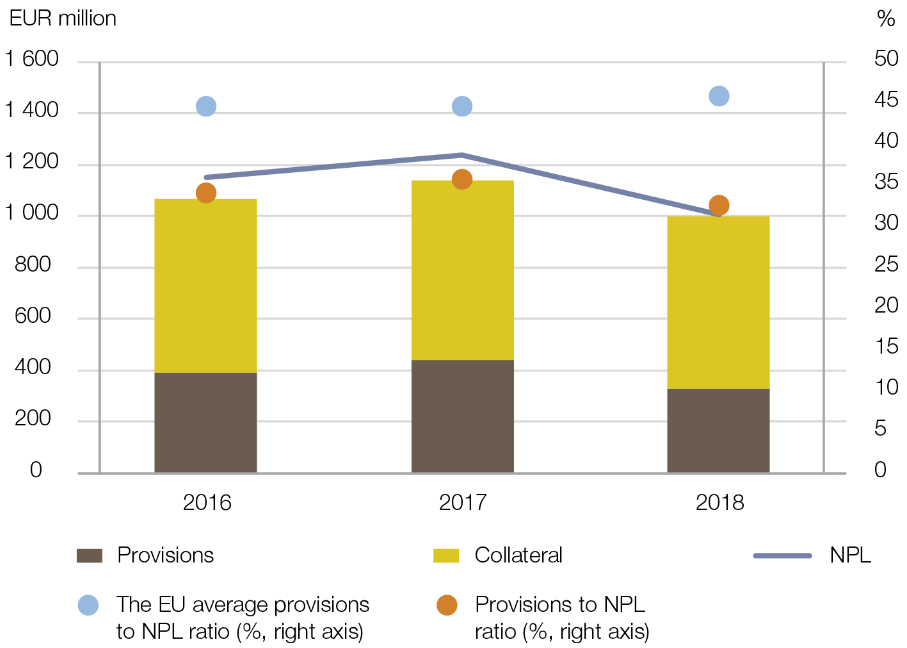


[13] As of 2018, in the publications by the FCMC the FINREP and COREP data provided by the banking sector are mainly used – the consolidated data of the banks under the consolidated supervision (i.e. the data on banks and their financial subsidiaries), as well as the data on other banks and foreign bank branches on an individual level.

[14] Loans past-due more than 90 days and loans that are not past-due or are past-due 90 days or less, but have an indication that the borrower is unlikely to pay (i.e. doubtful loans).

Figure 7

NPL, collateral and provisions for NPL, EUR million, provisions to NPL ratio, %



The provisions to the NPL ratio did not change significantly during the year and at the end of the reporting year it was 32.3%, which overall was a higher ratio than in the rest of the region of the Nordic countries (in Estonia – 26.7%, in Lithuania – 24.6%, in Finland – 26.7%, in Sweden – 33.1% and in Denmark – 28.1%, respectively), but still lower than the EU average ratio (45.1%). The provisions to the NPL ratio still remained at the risk level appropriate for our region, confirmed by the banks' internal provisioning models (based on historical loss rates) and the availability of credit collateral and constant rise in the housing price index over recent years, as well as banking practices for the taking over of collateral. At the end of the reporting year, the aggregate amount of NPL provisions and collateral value in fact fully covered the amount of such loans.

INSURANCE SECTOR

In 2018, the priority of the supervisory process of insurance companies was to ensure effective supervision pursuant to the requirements laid down in the Insurance and Reinsurance Law, by checking the compliance of the submitted documents with the statutory requirements and carrying out the on-site inspections of the activity of insurance companies.

In 2018, the FCMC carried out full on-site inspections of the activities of three insurance companies. The FCMC carried out on-site supervision and monitoring, based on the analysis of the reports and other information submitted by insurance companies, as well as the insurance companies were invited to present their approved operational strategies to the FCMC, thus facilitating mutual dialogue between the FCMC and insurance companies.

Based on the results of the analysis of the activities of insurance companies, the FCMC carried out the annual risk assessment of insurance companies, assigning a risk grade to each insurance company depending on the level of its risks and the quality of the management thereof, as well as pursuant to the impact of the insurance company on the insurance market.

The risk assessment and risk grading processes form part of a supervisory review process, which is based on an assessment of the impact of risks, and is one of its stages. This is a method used by the FCMC to identify, analyse and assess risks inherent to the activities of insurance companies and to assess the quality, adequacy and appropriateness of the risk management methods applied by them in terms of the nature, volume, and complexity of the operations thereof.

The key objectives of the risk assessment and risk grading process are:

- to assess the risks inherent to the activities of the insurance company, as well as its risk management system;

- to establish a standardised supervisory approach for risk identification, analyses and assessment;

- to summarise the results of the assessment in a concise and comparable manner (i.e. assigning a risk rating to each insurance company);

- to ensure efficient and targeted planning of supervision;

- to ensure the continuity and transparency of the supervisory process;

- to promote the introduction of more advanced risk management approaches in insurance companies;

- to promote communication and dialogue with insurance companies.

Once a year, after receiving the annual quantitative report and the periodic supervisory report and the evaluation of the information reflected therein, the FCMC assigns, for supervisory needs, a risk grade to each insurance company on a scale from "1" to "4", in which "1" stands for the highest rating, and "4" stands for the lowest rating.

According to the methodology approved by the FCMC, the risk level assigned to the insurance company is reviewed after completing a fully-fledged on-site inspection and on obtaining essential information about the activity of the insurance company, which might affect the previously assigned risk level.

The FCMC uses the risk grades of insurance companies determined as a result of risk assessment and the risk grade determining process to carry out effective supervision of insurance companies, by setting priorities and intensities for the off-site and on-site supervisory measures to be taken. According to the risk grade assigned to the insurance company, the supervision of the activity thereof is planned – for an insurance company with the highest rating (i.e. low risk activity), the necessary supervision measures are minimal, whereas for an insurance company with the lowest rating (i.e. high risk activity), continuous and enhanced supervision and control of the activity is required. The "Procedure for minimum frequency for the regular review of elements laid down in Section 44 of Insurance and actions for performing inspections" approved by the FCMC is available on the FCMC website under the section Legislation (http://www.fktk.lv/lv/tiesibu-akti/apdrosinasana/informacijas-atklasana-atbilstosi-regulas-es-2015-2451-prasibam/uzraudzibas-parbaudes-process/6419-uzraudzibas-parbaudes-process.html).

In 2018, as a result of the risk assessment carried out by the FCMC and determining of the risk grade, the following risk grades were assigned to insurance companies:

- risk grade "1" was not assigned to any company (the activity is characterised by a low level of risk and the methods used to manage the risks are sufficient);

- risk grade "2" was assigned to two companies (the activity is characterised by a moderate level of risks and the methods used to manage the risks are satisfactory; however, there is room for improvement);

- risk grade "3" is assigned to four companies (the activity is characterised by an increased level of risks and the methods used to manage the risks are not satisfactory, because there are significant deficiencies);

- risk grade "4" was not assigned to any company (the activity is characterised by a high level of risks and the methods used to manage risks are not sufficient, i.e. inconsistent with the risks, scale of activity, and complexity inherent to its activity).

As a result of full on-site inspections carried out in 2018 the assigned risk level was not changed to any insurance company.

In 2018, the FCMC carried out the thematic off-site inspection of the activity of all the insurers to assess the insurers' readiness to ensure the fulfilment of the requirements laid down in the Delegated Regulation (EU) 2017/2358 of 21 September 2017 supplementing Directive (EU) 2016/97 of the European Parliament and of the Council with regard to product oversight and governance requirements for insurance undertakings and insurance distributors.

During the supervision process carried out in 2018 no substantial violations of the requirements of the Insurance and Reinsurance Law were identified.

In 2018, the FCMC cooperated with the supervisory authorities of insurance and reinsurance companies of EU Member States, which are implementing the supervision of the insurance groups and reinsurance groups whose members were insurance companies licensed in Latvia. In 2018, FCMC staff participated in the colleges of insurance and reinsurance supervisors of three EU Member States and ensured the preparation and provision of information in accordance with the requests of group supervisory authorities.

The FCMC also cooperated with insurance supervisory authorities in Estonia and Lithuania in 2018, by organising the common meeting of the insurance supervisors of the Baltic states.

In 2018, the FCMC participated in the work of the EIOPA in the field of insurance supervision, ensuring the provision of information in accordance with the requests of the EIOPA, i.e. providing, on a quarterly basis, information for the needs of the preparation of the Risk Dashboard, providing information for the needs of the preparation of the Consumer Trends Report, Spring Financial Stability Report and Autumn Financial Stability Report, Costs and Past Performance Report, COM Report on Group Supervision and Capital Management with (Re)Insurance Group, and FoS and FoE under SII and LTG report, as well as answers to other information requests and ensuring the provision of information in accordance with the information requests from the International Association of Insurance Supervisors and the OECD.

Guarantee fund of the Compulsory Third-party Liability Insurance of the Owners of Motor Vehicles

In 2018, under Section 51 of the Compulsory Civil Liability Insurance of Owners of Motor Vehicles Law and Paragraph 19 of LR Cabinet Regulation No. 195 On the Procedure for Establishing the Guarantee Fund of Compulsory Third-Party Liability Insurance of the Owners of Motor Vehicles, for Accruing Assets in the Fund and Managing the Fund of 22 March 2005, the FCMC carried out a compliance inspection of the establishing, provisioning and administration procedures of the guarantee fund of the compulsory third-party liability of the owners of motor vehicles administered by the association Motor Insurers' Bureau of Latvia and notified the Ministry of Finance and the Motor Insurers' Bureau of Latvia of the findings of the inspection.

Insurance and reinsurance intermediaries

In 2018, the FCMC carried out off-site supervision of insurance brokers and of the Latvian branches of the insurance broker firms of EU Member States registered in the Register of insurance and reinsurance intermediaries maintained by the FCMC, which is based on the analysis of the submitted reports and other submitted information.

In 2018, the FCMC conducted a thematic on-site inspection of the activity of two insurance brokers, assessing their compliance with the requirements laid down in the Law of the Activity of Insurance and Reinsurance Intermediaries.

In the supervisory process carried out in 2018, no material violations of the requirements determined in the Activities of Insurance and Reinsurance Intermediaries Law were identified, for which the sanctions would be applied foreseen in the aforementioned law.

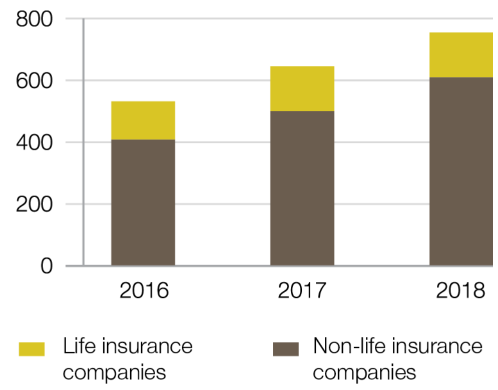
Insurance sector performance indicators

At the end of the reporting year, the same as in the previous year, there were six insurance companies in Latvia (two life insurance and four non-life insurance companies), as well as 11 branches of EU Member State insurance companies (four life insurance and seven non-life insurance company branches).

Premiums written

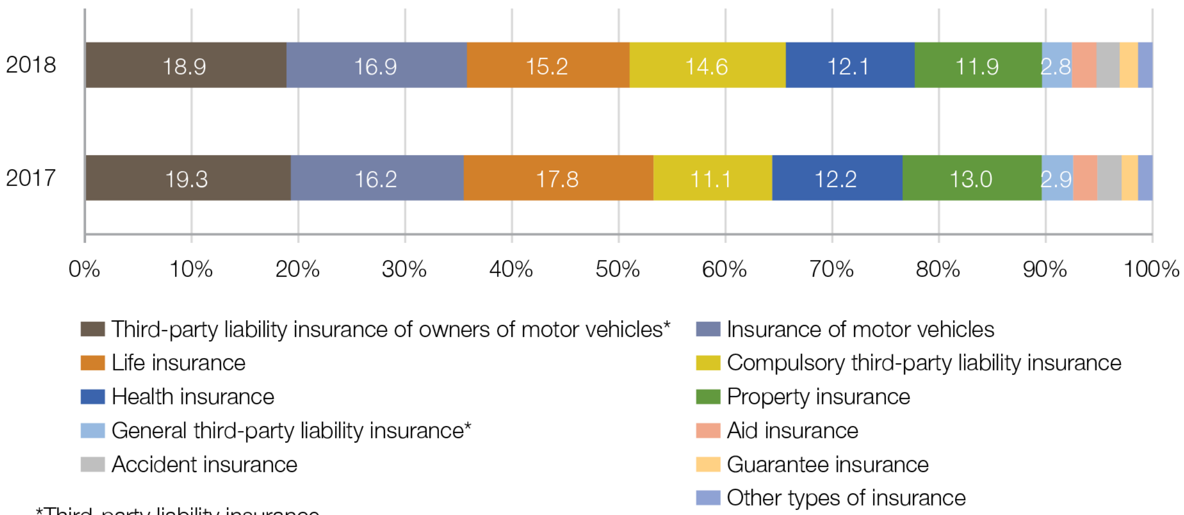
In 2018, the growth rate of the amount of the gross premiums written by the insurers maintained a steep rise and the premiums written in Latvia per capita reached the historically highest level, i.e. EUR 271. The total amount of gross premiums written grew by 17% during the reporting year, reaching EUR 758 million. Both Latvian economic growth (the premiums written in Latvia formed the majority/largest part, i.e. 68.8%, the annual growth rate reached 18.1%) and the expanded activities of the insurers in other EEA Member States outside Latvia, mainly in Estonia and Lithuania, promoted the development of the insurance market in general (the annual growth rate was 14.7%).

Figure 8
Premiums written by insurers, in EUR million



In the total portfolio of premiums written, premiums of transport insurance (motor vehicle insurance, motor vehicle owner third-party liability insurance and CTPLI) dominated, reaching 50.4% or EUR 381 million, including almost all motor vehicle owner third-party liability insurance premiums were written in other EEA member states. In turn, the most significant insurance types in Latvia were life insurance (22.2%), CTPLI (21.3%) and health insurance (17.1%).

Figure 9
Gross written premiums by type of insurance, in EUR million



*Third-party liability insurance.

Figure 10 Combined ratio

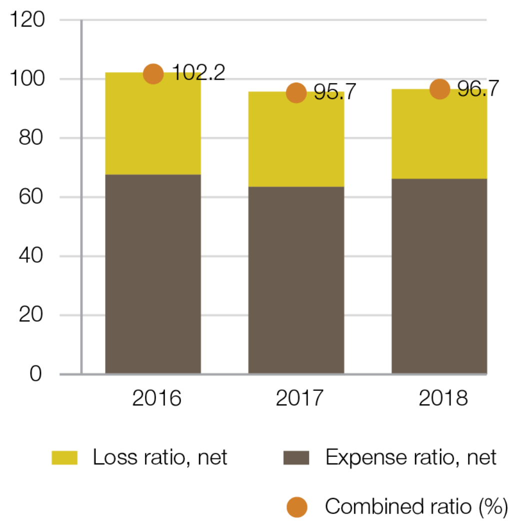
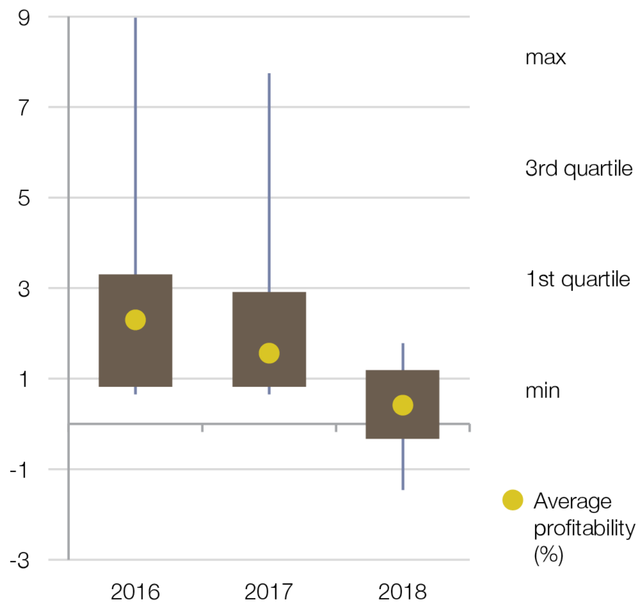


Figure 11 Return on investments



Earning capacity. During the reporting year, insurance companies earned EUR 12.4 million in total, while the earning capacity trends of insurance companies varied. The increase of policy prices in transport insurance types positively affected the realised profit by non-life insurance companies, and it reached EUR 16.9 million. In turn, the negative performance of life insurance companies, i.e. the loss in the amount of EUR 3.7 million, was mainly determined by the growth of compensation disbursements and the increase of operating expenses.

The amount of approved indemnity claims of non-life insurance companies grew more rapidly than the amount of premiums earned, the combined ratio slightly deteriorated, reaching 96.7% at the end of the year, including for individual insurance companies it ranged from 92.3% to 103.9% (the rise of the ratio above 100% indicates the losses from the non-life insurance activities, not including the investment income).

Overall, return on investments remained low (0.4%) and for individual insurance companies it ranged from -1.5% to 1.8%. Negative fluctuations of the financial market had a significant impact on the investments in financial instruments (stocks, Investment fund certificates) made by life insurance companies, and the return on investments of these companies remained negative, while the conservative investment policy of non-life insurance companies ensured a positive return on investments.

Solvency. The average solvency ratio (the adequacy of own capital to the solvency capital requirement, which, under the Solvency II supervisory regime, is being determined, on the basis of risk assessment) of insurance companies did not change substantially during the reporting year and remained higher than the minimum requirements (the lowest allowable limit of the indicator is 100%), including 132.2% for life insurance companies and 128.7% for non-life insurance companies.

COOPERATIVE CREDIT UNIONS

In 2018, the supervision of cooperative credit unions was carried out both by monitoring their performance based on the analysis of financial statements, with a special focus on the sufficiency of the provisions for doubtful debts made by the credit unions and for the covering of losses, as well as by carrying out on-site inspections. During the reporting year, FCMC experts carried out four on-site inspections aimed at assessing the financial standing of the cooperative credit unions, management performance, quality of assets, income and cost structure, as well as the compliance of their activities with the requirements of laws and regulations.

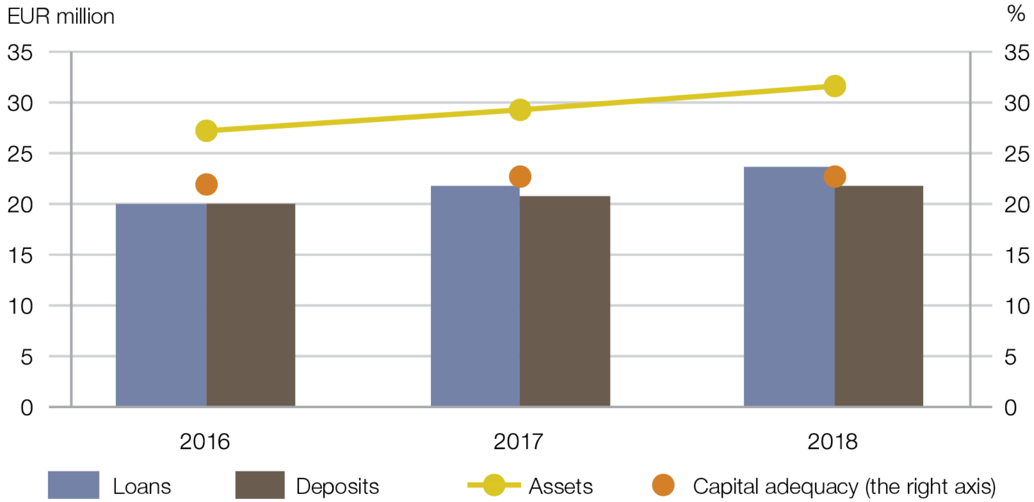
When implementing the supervision of cooperative credit union activities, one union's licence was withdrawn in 2018. In turn, the FCMC issued licences to two credit unions for the activities of credit unions in 2018.

Performance indicators of cooperative credit unions

At the end of the reporting year, there were 34 cooperative credit unions in Latvia; and the total trend of the asset increase remained stable – during the reporting the total asset volume of cooperative credit unions increased by 7.9% or EUR 2.3 million, reaching EUR 31.6 million at the end of December. The increase in assets according to the business model of cooperative credit unions was ensured by the contributions by members in EUR – the amount thereof increased by 6.8% during the year and reached EUR 22.3 million at the end of December, including a majority or approximately 88% were deposits by households. Contributions by members were the major source of the assets attracted by unions (99%).

All working cooperative credit unions worked providing capital adequacy ratios above the minimum capital adequacy requirement (10%), and the total own funds of cooperative credit unions to the sum total of the assets and off-balance items ratio, i.e. the capital adequacy ratio, was 22.7% at the end of December.

Figure 12
Assets, loans, deposits and capital adequacy of credit unions



Slower than in the previous year, but the amount of loans granted to members continued to increase – it increased by EUR 1.3 million or 6% during the reporting year, reaching EUR 23.6 million at the end of December. The growth of the credit portfolio was driven by consumer loans and home acquisition loans, i.e. the key types in the loan portfolio (correspondingly, 43.2% and 45.2% of the total loan portfolio). Approximately 99% of the credit portfolio was loans issued to households.

The high market concentration level in the cooperative credit union sector (three unions together form almost 85% of the particular market segment) creates situations when the activity of individual market participants significantly affects the performance indicators of the whole sector. At the beginning of the reporting period, with one cooperative credit union having performed reclassification of its loan portfolio, a significant part of the supervised loans[15] were reclassified in the higher quality, i.e. standard loan, category, significantly improving the quality indicators of the loan portfolio in the sector as well. In turn, another cooperative credit union clarified the quality assessment methodology for its rapidly growing consumer loan portfolio in the middle of the reporting period, and thus a part of the supervised loans was reclassified in lower category loans (substandard, doubtful and lost) and the share of these loans grew significantly in the total loan portfolio of the sector as well. Therefore, even though the share of standard loans increased significantly in the total loan portfolio of the sector during the year (from 57.6% to 76.8%), still the rapid increase of the substandard, doubtful and lost loan share (from 4.4% to 13.5%) did not indicate a significant improvement overall in the sector. The amount of provisions created for bad debts amounted to 6.3% of the total loan portfolio of credit unions at the end of the year (or 46.9% of the total amount of substandard, doubtful and lost loans).

During the reporting year cooperative credit unions earned EUR 792 thousand in total, ROE reaching 11.7% at the end of December. The majority of credit unions worked with profit, and 24 (out of total 32) unions earned EUR 800 thousand. The main source of income of cooperative credit unions – net interest income – almost did not change during the reporting year (decreased by 0.3%); however, a positive effect on the amount of profit earned was not only due to a significant increase in provision reduction income (by 58.5%), but net commission income also grew (by 18%) as well as net income from transactions in financial instruments, mainly from trade in foreign currencies (by 22.7%). At the same time, the most significant expense item of credit unions grew slightly, i.e. administrative expenses (by 3.8%).

PAYMENT INSTITUTIONS AND ELECTRONIC MONEY INSTITUTIONS

In 2018, the FCMC carried out supervisory measures of payment institutions and electronic money institutions, based on the service business model provided by the institutions, the associated risks and their grade to which greater attention was paid. In 2018, the supervision of payment institutions and electronic money institutions was carried out, also taking into account the monitoring of the performance of the institutions, which was based on the scope of activity and the trend analysis, as well as the analysis of the submitted financial statements. In 2018, the FCMC continued paying special attention to the analysis of the client base of payment institutions and electronic money institutions. Payment institutions and electronic money institutions are required to submit a report on customer assets, in which payment institutions present information about payments which were commenced and completed by the institution, specifying the mean average value of the payments performed within the previous 12 months, whereas electronic money institutions present the average volume of electronic money in circulation for the last six months, as well as information on the amount of repurchased electronic money. Also in 2018, the FCMC focussed on the financial stability of payment institutions and electronic money institutions: The FCMC, in order to control the amount of equity capital, requested information regarding the balance sheet statements and profit and loss account not only from the licensed institutions, but also from the registered institutions. In 2018, one on-site inspection was commenced in a payment institution, as well as a previously commenced inspection at an electronic money institution was finalised. The goal of inspections was to assess the operational model of the payment institution and the electronic money institution and compliance of the operations with the requirements of the laws and regulations, especially those laid down in the LPSEM and AML/CTF Law. Implementing the supervision of payment institution and electronic money institution activities, in 2018 the FCMC concluded three administrative agreements for the elimination of the deficiencies and inconsistencies identified in the activities of payment institutions and electronic money institutions as a result of supervisory measures. The registration in the FCMC payment institution register was cancelled for seven payment institutions and six electronic money institutions.

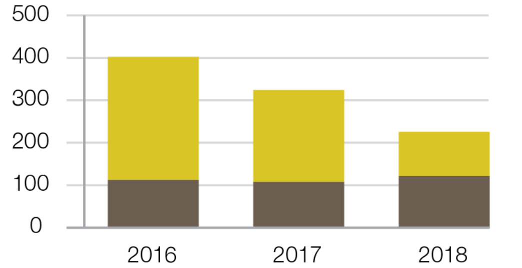
[15] Cooperative credit unions classify the loans in the following categories: standard, subject to supervision, substandard, doubtful and lost loans.

Performance indicators of the payment institutions and electronic money institutions

Changes in the regulatory framework[16] in the field of payment institution and electronic money institution licensing determined the decrease of payment institution number. At the end of the reporting year, 15 payment institutions (including 12 registered and three licensed payment institutions) and 13 electronic money institutions (including 10 registered and three licensed electronic money institutions) were operating in Latvia. Compared to 2017, the number of payment institutions and electronic payment institutions decreased in 2018 by 31.8% and 31.6%, respectively. The decrease in the number of payment institutions and electronic money institutions was related to the changes in legal acts, namely, the licensing regime for market participants was changed by determining stronger criteria for institutions wishing to work in the status of a registered institution. The decrease of the number of institutions was also affected by the changes in the laws and regulations in the field of AML/CTF. The aforementioned changes also affected the total amount of the payments performed by payment institutions and electronic payment institutions, which decreased by 29.6%. In the reporting year the total amount of repurchased electronic money decreased as well (by 52.2%).

The reputational risk reduction measures implemented in the financial sector that also determined refusing business with high risk clients, significantly affected the activities of payment institutions and electronic money institutions and the business volume reduced overall. The payments performed by these institutions decreased significantly – during the reporting year payments were performed in the amount of EUR 226 million, i.e. 30% less than in the previous year.

Figure 13 Total annual amount of performed payments, in EUR million



Even though the total amount of the liquid assets (funds for the fulfilment of the payments of clients) of the sector decreased, reaching EUR 16.9 million (including claims towards the banks for securing payment services – EUR 12.6 million) at the end of December 2018, it still ensured the covering of the payables owed to the clients (EUR 6 million), including the payables owed to the users of payment services (EUR 2.2 million).

As business volumes decreased, during the reporting year the total amount of electronic money repurchased by electronic money institutions also reduced significantly (i.e. the exchange of the issued electronic money to cash), reaching EUR 29.3 million at the end of December, which was 54% less than in the previous year.

INVESTMENT MANAGEMENT COMPANIES AND MANAGERS OF ALTERNATIVE INVESTMENT FUNDS

Supervisory measures applied to investment management companies

In 2018, the FCMC carried out off-site supervision of investment management companies and investment funds to assess their financial standing, quality of assets, income and costs structure and compliance of their activities with the requirements of the LR laws, FCMC regulations and guidelines, as well as other laws and regulations.

In the off-site inspection field regular reports were received and analysed in 2018:

Number of reports	Reports by investment management companies	Reports by investment funds	Total
Per month		52	52
Per quarter	33	72	105
Per annum	132	912	1,044

[16] The changes in the licensing and registration regime determined stronger requirements for the registration of institutions, concurrently determining a requirement for the reregistration of the existing market participants.

Conformity assessment of key information aimed at investors was carried out, as well as an assessment of whether the synthetic indicators of investment funds set by the investment management funds corresponded to the fluctuation of the profitability of the funds.

Closer attention was also paid to off-site analysis of the internal control system and internal audit of investment management companies, as well as the assessment of the key risks to companies, their strategic objectives, changes in the management information system, the assessment of risks related to outsourced services received, as well as the planned changes in the area of investment management.

Large exposure profile assessment of investment management companies and investment funds was carried out.

During the reporting year, one on-site inspection of the investment management company was also carried out. The purpose of the inspection was to assess the main areas of activity of the company, their compliance with the requirements laid down in the LR law, the regulations and guidelines issued by the FCMC, and other laws and regulations. Special focus in the course of inspection was placed on the control system developed by the company and to risk management, by assessing the compliance and usability of the internal legal framework basis. During the inspection, the transparency of the company's activity and compliance with best practice principles, as well as observance of the interests of the clients were assessed.

The deficiencies and inconsistencies identified during the inspection were discussed with the management of the company and action plans for necessary adjustments were agreed upon to ensure the successful functioning of the company.

Follow-up monitoring was carried out within the scope of off-site supervision by controlling the introduction of the action plan and, where necessary, recommending the necessary adjustments.

Supervisory measures applied to the managers of alternative investment funds and alternative investment funds

In 2018, off-site supervision of the AIFM was carried out to assess the structure of investments managed by them, the income and expense structure, and compliance of their activities with the requirements of the LR laws, the regulations and guidelines issued by the FCMC, and other laws and regulations.

In the off-site inspection field regular reports were received and analysed in 2018:

Number of reports	AIFM reports	AIF reports	Total
Per month		20	20
Per quarter	56	88	144
Per annum	225	594	819

Special attention was paid to the use of asset evaluation methods for the determination of the value of the assets.

Also, within the scope of the off-site supervision constant follow-up monitoring of the introduction of the action plan for the elimination of deficiencies and inconsistencies identified during on-site inspections is carried out, by controlling the introduction of the action plan and, where necessary, recommending the necessary adjustments.

In 2018, a large-scale assessment of the risk portfolio of the AIFM and AIF was carried out.

In 2018, one on-site inspection of a licensed AIFM was carried out. In the course thereof special attention was paid to the internal control system of the asset manager, the appropriateness of the segregation of functions of the asset manager to the established organisational structure, decision-making and fulfilment of management decisions, conformity and application of the internal regulatory base and the established reporting system.

Follow-up monitoring was carried out within the scope of off-site supervision by controlling the implementation of the action plan for the elimination of deficiencies and inconsistencies identified during the inspection and, where necessary, recommending the necessary adjustments.

Performance indicators of the investment management companies and managers of alternative investment funds

At the end of 2018, 11 investment management companies and 20 AIFM (including four investment management companies) were operating in Latvia. At the end of the year, the amount of assets under the management of the investment management companies reached almost EUR 4.3 billion, whereas the amount of assets under the management of the AIFM reached EUR 163.9 million at the end of December.

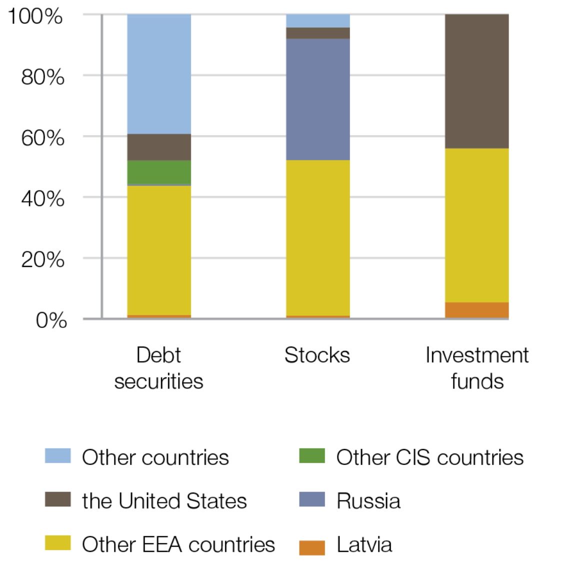
Performance indicators of investment funds

At the end of 2018, 23 investment funds registered in the FCMC were operating in Latvia, including 13 bond funds, three mixed funds and seven stock funds.

Over the year, the assets of bond and stock funds slightly decreased (by 6.1% and 10.2%, respectively), while the assets of the mixed funds grew by 4.9%. Total investment fund assets decreased by 5.9% over the year, reaching EUR 203.4 million at the end of December, including the assets of bond funds amounting to EUR 167.2 million and EUR 14.6 million – of mixed funds, and EUR 21.6 million of stock funds.

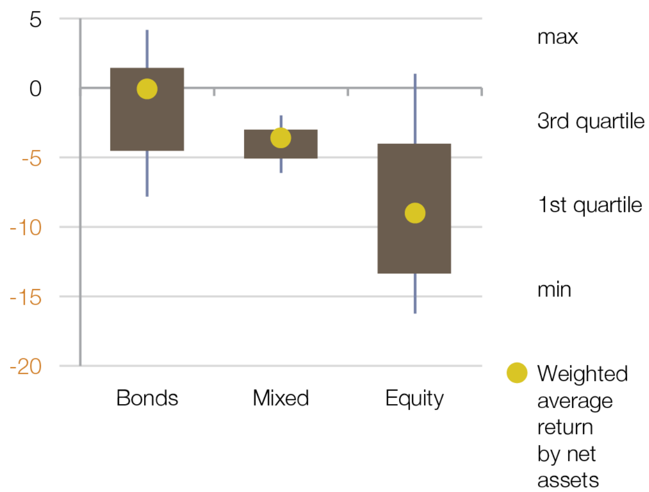
Debt securities accounted for the major share of the overall securities portfolio of the investment funds (84%), followed by investment fund investment certificates (12%), as well as stocks and other variable-yield securities (4%). An important share of all asset classes consisted of investments in securities issued by EEA-based issuers. Investments in debt securities are focussing on a high-yield/high-risk segment, i.e. 71% of debt securities had a credit rating below the investment level (below BBB-) or were unrated. The majority, i.e. 68% of the investment fund certificates were exchange traded funds (ETFs) (source: Bloomberg). In turn, investments in stocks focussed on the energy, raw materials and financial sectors.

Figure 14 Securities portfolio of investment funds by type of financial instruments and by group of countries (by the country of registration of the issuer) at 31 December 2018



All stock and mixed funds, excluding one, had a negative return, whereas the majority of bond funds ended the year with a positive return. The performance of funds to a large extent was determined by the currency of their investments, i.e. high performance in terms of the Euro was shown by the funds whose investment currency is the US dollar, the value whereof grew compared to the Euro during 2018. The annual return of the bond funds ranged from -7.8% to +4.2%, mixed funds from -6.1% to -2.0%, while the stock funds from -16.2% to +1%.

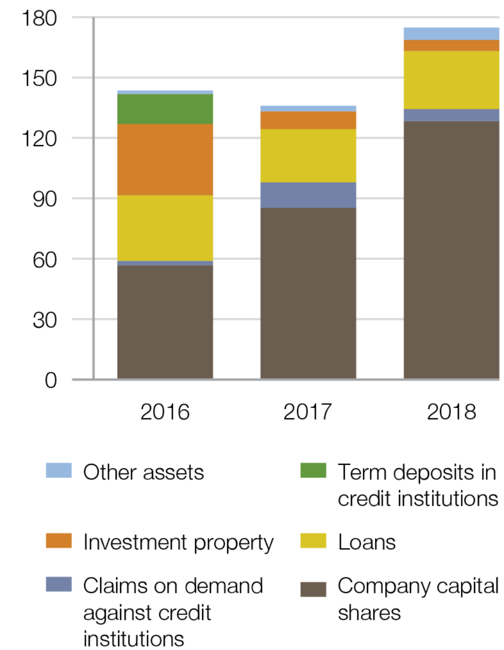
Figure 15 Annual return of investment funds by type of fund at 31 December 2018, %



Performance indicators of alternative investment funds

At the end of the reporting year, 30 AIF were operating in Latvia. During the year, the assets thereof increased by 28.6%, reaching EUR 174.8 million at the end of December. Along with new investments, as well as the revaluation of investment properties the assets of real estate investment strategy funds grew by 61.3%, reaching EUR 55.7 million at the end of the reporting period, whereas the assets of private capital investment strategy funds, along with new investments in companies, grew by 17.4%, reaching EUR 119.1 million at the end of December. The majority of the total AIF assets were comprised of company capital shares (EUR 128.4 million) and loans (EUR 28.8 million). At the end of the year, 72% of the assets of AIF were invested in Latvia, 14% in Estonia and 14% in Lithuania.

Figure 16
AIF asset dynamics, in EUR million



STATE-FUNDED PENSION SCHEME

In 2018, the FCMC carried out off-site supervision of the asset managers of the SFPS to assess the quality of assets of investment plans managed by them, the income and expense structure, and compliance of their activities with the requirements of the LR laws, the regulations and guidelines issued by the FCMC, and other laws and regulations.

In the off-site inspection field regular reports were received and analysed in 2018:

Number of reports	SFPS investment plan reports
Per month	57
Per quarter	84
Per annum	1,020

During the reporting year, within the scope of off-site supervision, the FCMC also assessed the critical situation analysis submitted by asset managers of the SFPS for the investment portfolio of each investment plan. The specified risk factors, assessed scenarios and anticipated activities to be carried out in the event of adverse scenarios setting in were assessed.

While carrying out off-site supervision, the internal audit function of asset managers was also assessed by requesting them to submit internal audit plans and prepared opinions and evaluating them. Meetings were also held with the management of asset managers to monitor the key events in the activities of market participants and the fulfilment of business strategies in between on-site inspections.

In 2018, the large-scale assessment of the risk portfolio of the SFPS investment plans was carried out.

In addition:

- the key information aimed at the members of all SFPS investment plans was received and reviewed in accordance with FCMC Regulation No. 295 Regulations on the Preparation of the Key Information to the Members of the State-Funded Pension Scheme of 10 December 2014;

- investment plan expenses were assessed and in-depth analysis of their structure was carried out, taking into consideration changes in legal acts;

- the monitoring of the capital increase process of the asset managers of the SFPS was carried out, in order to verify compliance with the new capital requirements.

In 2018, the on-site inspection of the activity of one SFPS assets manager was carried out. In the course thereof special attention was paid to the internal control system of the asset manager, the appropriateness of the segregation of functions of the asset manager to the established organisational structure, decision-making and fulfilment of management decisions, conformity and application of the internal regulatory base and the established reporting system. Particular attention was paid to the engagement and use of outsourced services, assessing the control systems established by the asset manager to assess the outsourced services. The activities of asset holders were also assessed. The deficiencies and inconsistencies identified during the inspection were discussed with the management of the SFPS asset managers and action plans for necessary adjustments were agreed upon to ensure the successful functioning of the pension fund.

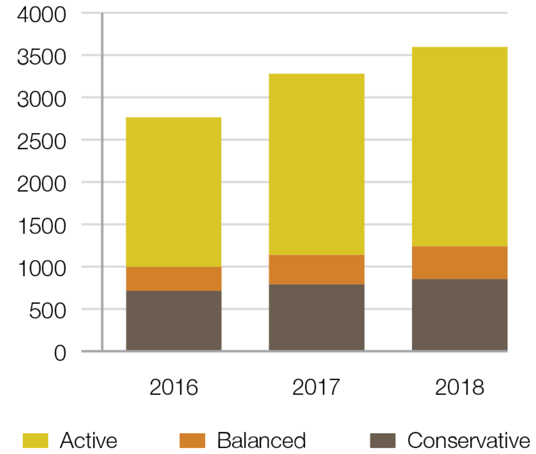
Follow-up monitoring was carried out within the scope of off-site supervision by controlling the introduction of the action plan and, where necessary, recommending the necessary adjustments.

Performance indicators of the state-funded pension scheme investment plans

At the end of the reporting year, 29 investment plans of the SFPS were operating in Latvia, including eight conservative plans, four balanced plans and 17 active plans. The pension capital accrued in the investment plans grew by 9.6% or by EUR 316.3 million in 2018, totalling EUR 3.59 billion at the end of the year. Net assets grew for all types of investment plans.

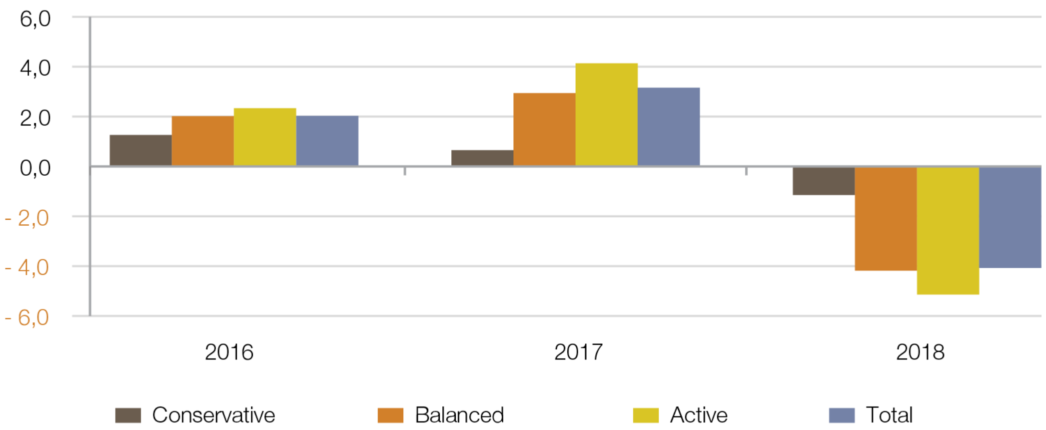
Figure 17

Accrued pension capital by type of investment plan, in EUR million



Along with the negative trends in financial markets that were driven by the growing investor concerns about the trade tariff wars between the USA and China and about the growth of the global economy, as well as the uncertainty in relation to the withdrawal of the United Kingdom from the EU, all investment plans performed with a negative return in 2018. In the reporting year, the return of conservative investment plans ranged from -2.8% to -0.4%, for balanced plans it ranged from -5.2% to -2.9%, while for active plans – from -10.8% to -2.5%.

Figure 18
Weighted average (by net assets) annual return of investment plans, %



Along with the changes in the Law on State Funded Pensions that came into force on 1 January 2018 and laid down a new ceiling in relation to the maximum fees, the managers significantly decreased the investment plan management expenses and in comparison with 2017 they dropped by approximately half – for the active plans from 1.6% to 0.7%, for the balanced plans – from 1.3% to 0.7% and for the conservative – from 0.9% to 0.5%.

Investment policy of investment plans remained conservative overall; however, during the year a trend was marked to invest more in financial instruments with a higher potential return. In light of the low interest rate environment, the share of debt securities and claims against credit institutions decreased in the total investment plan portfolio, whereas the share of investment fund certificates grew, at the end of the year reaching 48.5%, including the majority or 53% focussed on equity securities (source: Bloomberg). Debt securities had the second largest share in the investment portfolio, i.e. 42.2%. At the end of the year, 77.6% of the debt securities had the investment credit rating (source: Bloomberg), and the share of such securities tended to decrease. Investments in AIFs and venture capital slightly increased, reaching 4% of total investments at the end of the year (3.3% at the end of 2017).

As new investments were mainly made outside Latvia, the share of investments made in Latvia continued to decrease. Investments in Latvia dropped by 2.9% during the year, reaching EUR 689.7 million at the end of December or 19.1% of total investments (including EUR 348.6 million investments in the securities issued or guaranteed by the government, EUR 70.9 million – in debt securities of commercial companies, EUR 3.4 million – in stocks, EUR 36.3 million – in investment funds, EUR 25.7 million – in the Latvian venture capital market, whereas EUR 204.2 million was placed with credit institutions). 93% of all foreign investments were placed in EEA Member States, including the majority in Luxembourg, Ireland and Lithuania.

PRIVATE PENSION FUNDS AND PENSION PLANS

In 2018, the off-site supervision of private pension funds was carried out by assessing the financial standing of private pension funds, quality of assets of pension plans, the income and costs structure and compliance of their activities with the requirements of the LR laws, FCMC regulations and guidelines, as well as other laws and regulations.

In the off-site inspection field regular reports were received and analysed in 2018:

Number of reports	Private pension fund reports	Pension plan reports	Total
Per quarter	24	144	168
Per annum	96	576	672

In the reporting year, two on-site inspections of private pension funds were also carried out to assess the activities of the pension funds when carrying out the functions specified in the Law on Private Pension Funds. During the inspections, particular attention was paid to the appropriateness and sustainability of the internal control system established by the pension fund and the identification and management of material risks. Segregation of functions and appropriateness to the established organisational structure were analysed as well as the capacity of information exchange and the reporting system established by the pension fund to ensure sufficient and easily traceable information to internal and external users. Particular attention was paid to the selection and use of outsourced services, assessing the control systems established by the pension fund to assess the outsourced services. Within the scope of inspection of each pension fund, the activity of the manager of the funds thereof and the holder of the funds thereof was also assessed. During the inspection, the FCMC also assessed the risk trends of the products offered by the pension funds.

The deficiencies and inconsistencies identified during the inspection were discussed with the management of the private pension funds and action plans for necessary adjustments were agreed upon to ensure the successful functioning of the pension fund. Follow-up monitoring was carried out within the scope of off-site supervision by controlling the implementation of the action plan and, where necessary, recommending the necessary adjustments.

Within the scope of off-site supervision, the FCMC also assessed the critical situation analysis submitted by private pension funds for the investment portfolio of each pension plan. The specified risk factors, assessed scenarios and anticipated activities to be carried out in the event of adverse scenarios setting in were assessed.

Within the scope of off-site supervision, in the reporting year, the functioning of the internal audit of the private pension funds was also assessed, evaluating the internal audit plans and prepared opinions.

An extensive assessment of the risk profile of private pension funds was carried out.

Also, meetings were held with the management of private pension funds to monitor the key events in the activities of market participants and the fulfilment of business strategies in between on-site inspections.

During the reporting year, active work was also carried out in the area of pension fund supervision in committees at the European level. The FCMC representatives actively participated in the work of the EIOPA in the field of pension fund supervision, by providing answers to surveys and self-assessments, as well as taking part in the work of the Occupational Pensions Committee that dealt with topical pension fund supervision issues at the European level. Active part was also taken in the EIOPA Review Panel. A representative of the FCMC participated in the Peer Review on Prudent Person Rule for IORPs as a project leader. During the project the practices of Member State supervisory authorities regarding prudent and diligent host principle supervision were reviewed, with pension funds investing in pension capital. As a result of this analysis 27 recommendations were set to 19 supervisory authorities from 16 Member States, as well as six best practice examples were identified. Find the EAAPI review here: https://eiopa.europa.eu/Pages/News/EIOPA-identifies-areas-for-improvement-in-the-supervision-of-Prudent-Person-Rule-compliance-by-institutions-for-occupationa.aspx.

Also, during the reporting year, the representatives of the FCMC participated in the work of the committees set up by the OECD in the field of pensions.

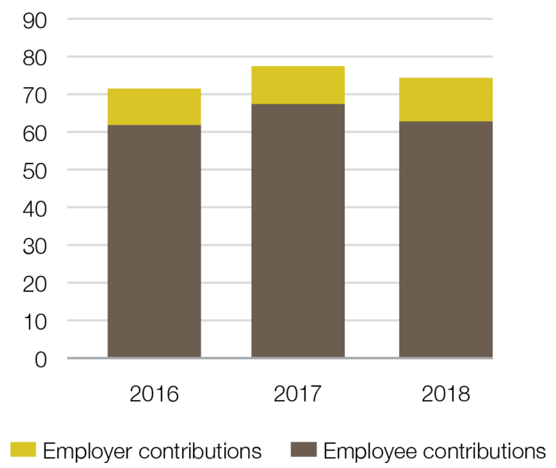
In order to strengthen the supervision framework, during the reporting year internal normative documents in the field of on-site inspections were updated, in order to emphasise a risk-based approach for carrying out inspections and to provide a review to market participants in a more understandable way about their risk profile according to the results of on-site inspections and in the field of sanction and corrective measure application.

Performance indicators of private pension funds

At the end of the reporting period, there were five open-end pension funds and one closed-end pension fund in Latvia, administering 18 pension plans in total.

Along with more rapid economic growth employers restarted paying contributions more actively in third-pillar pension plans, whereas the amount of contributions paid by inhabitants decreased which may be related to the changes in legal acts that determined new ceilings for the amounts from which the paid taxes can be recovered. During 2018, a total of EUR 77 million was paid into pension plans, i.e. 0.8% less than in the previous year. From pension plan capital almost EUR 25 million was disbursed during the year, or 29% less than in 2017. At the end of the year, the capital accumulated by third-pillar pension plans amounted to EUR 461.3 million, having increased by 6.2% during the year.

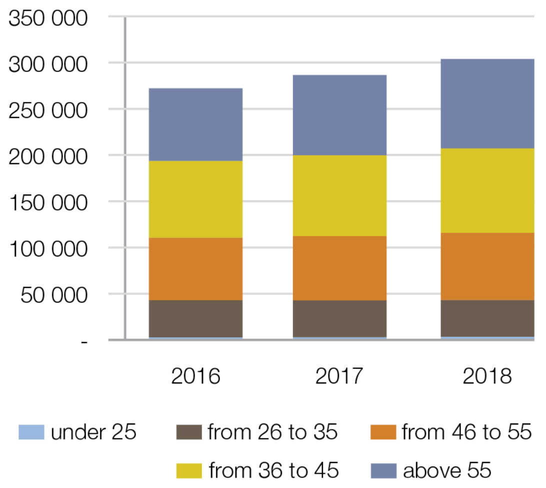
Figure 19
Contributions to pension plans, in EUR million



During the year, the total number of participants having joined the private pension plans increased by 17.3 thousand or by 6.1%, amounting to 303,849 participants, namely, 31.1% of economically active Latvian residents at the end of the year. According to the age structure of third-pillar pensioners, participants approaching retirement age are more actively involved in making pension savings.

Figure 20

Breakdown of the number of pension plan participants by the age of participant

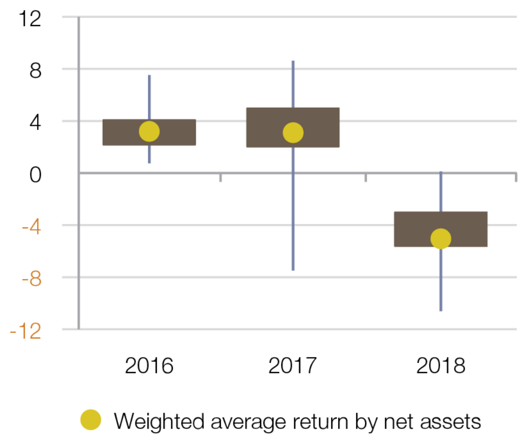


Negative trends in financial markets were also reflected in the performance of pension plans, and the average return of pension plans was -5.1% in 2018 (for individual plans it ranged from -10.6% to +0.2%). Pension plans, where the investment currency was the US dollar showed less negative results.

In order to maintain competitiveness, managers also reduced the management expenses for the private pension plans, and thus the ratio of the administrative expenses

Figure 21

Average weighted annual return of pension plans, %



and investment management expenses to net assets decreased from 1.8% to 1.4% during the year, that was influenced by the decrease of the ratio of management expenses to net assets from 1.2% to 0.7%.

Investment structure of private pension plans did not change significantly during the year; however, a trend was marked to invest more in financial instruments with a higher potential return. Investment fund certificates accounted for the major share in the structure of portfolio of pension plans (54%), of which 52% had a focus on investments in equity securities, and 40.4% had a focus on investments in fixed income instruments (source: Bloomberg). Affected by the low interest rate environment, the share of claims against credit institutions declined in the total pension plan investment portfolio, reaching 7.2% at the end of the reporting period. Compared to the end of 2017 the share of debt securities increased slightly, reaching 37% at the end of the year. In the structure of debt securities trends such as increase of the share of debt securities issued by commercial companies and decrease of the share of debt securities with an investment credit rating were observed, namely, 79.2% of debt securities had an investment credit rating at the end of the year (source: Bloomberg).

During the year, investments in Latvia dropped by EUR 6.6 million, amounting to EUR 87.8 million at the end of December, and the share of these investments in the total portfolio had also dropped to 19% at the end of the year. Investments in other EEA Member States accounted for 78.8% of all investments.

INVESTMENT SERVICE PROVIDERS

At the end of the reporting year, investment services were provided by five investment firms licensed in Latvia, 14 credit institutions registered in Latvia, nine investment management companies registered in Latvia and four branches of EU Member State-based credit institutions. Likewise, more than 2,000 investment service providers from the EEA countries were also entitled to provide investment services according to the principle of freedom to provide services.

As in previous years, also in 2018, regular off-site measures were carried out that were basically related to the evaluation of reviews, reports and other information submitted by market participants. In 2018, the supervisory practice launched in 2016 was continued, namely, meetings with the management of the structural units of market participants providing investment services, during which market participants presented their activity in the investment services sector, as well as the measures already taken and plans related to internal control measures in providing investment services. During the reporting year, such meetings took place at eight market participants.

In 2018, one on-site inspection was carried out as well. In addition one mystery shopping inspection was carried out which was used to evaluate how the agent engaged by another Member State provider of investment services complied with the requirements of the FIML. Information obtained was sent to another Member State's supervisory authority to ensure further supervisory actions.

In 2018, thematic or horizontal inspections were introduced in the supervisory practices of the sector of providers of investment services. Taking into account that in 2018 the amendments of the FIML came into force in relation to the introduction of MiFID II and MiFIR and other regulations shall be applied as of 2018, horizontal inspection is one of the most appropriate measures to foster market participants observing the new requirements in their activities, as well as to evaluate the measures carried out by market participants to ensure the fulfilment of these requirements. In total five horizontal inspections were carried out in 2018, of which four were finalised at the end of the reporting year, while the information provided by the market participant was still assessed within one inspection.

In order to facilitate the MiFID II implementation process and foster the compliance of investment service providers, in 2018 the FCMC regularly published responses to market participants' questions regarding the application of FIML or MiFID II norms on its website.

In 2018 no such violations were identified, for which sanctions or other types of corrective measures should be applied, but for the elimination of the drawbacks and deficiencies identified within the framework of off-site horizontal inspections carried out, the FCMC provided market participants with individual guidance on the elimination of deficiencies.

Performance indicators of investment firms

In 2018, five investment firms were operating in Latvia. Though overall the segment operated with loss in the amount of EUR 0.4 million, two firms ended the year with profit. The amount of profit gained dropped along with a significant decrease in fee income (by 40.5%), which was mainly due to the narrowing of the activity of one company within the group of the bank in liquidation (the amount of services provided by it related to the provision of services to the clients of the parent bank), as well as the restrictions imposed by the ESMA on transactions related to contracts on price difference (CFD) with private investors.

Income and expense structure of investment firms did not change significantly during the reporting year – income from commission fees and other similar income for the services rendered to customers accounted for 90% of all revenue of investment firms, whereas administrative expenses was the highest expense item (it comprised 80% of total expenses).

During the reporting year, the common equity Tier 1 capital ratio of investment firms increased, reaching 31.4% (for individual market participants it ranged from 15.3% to 57.2%) at the end of the year. Overall, the increase of the capital ratio was determined by capital strengthening measures performed by individual firms, by including the audited profit of the preceding year in the capital.

In 2018, two firms were engaged in the holding of financial instruments for customers, under the licences issued to them for providing non-core investment services, whereas none of the firms holding licences for the individual management of the financial instruments of investors were transferred customer assets for management. During the reporting year, the amount of cash owned by customers held by investment firms for the performance of transactions in financial instruments, grew insignificantly (by EUR 0.5 million or 5.4%).

FINANCIAL INSTRUMENTS MARKET

Supervision of the points of sale of financial instruments and the Central Securities Depository

As in previous years, at the end of the reporting year, there was one regulated market – Nasdaq Riga (hereinafter – Stock Exchange) and one multilateral trading system or alternative market – First North Latvia operating in Latvia. Both points of sale are organised by AS Nasdaq Riga.

The task of the FCMC is to supervise the activities of the points of sale of financial instruments, regularly following whether the points of sale ensure the fulfilment of the requirements of the legal acts regulating their activities, including the disclosure of information on the submitted orders and the concluded transactions. Likewise, the FCMC evaluates the documents submitted by the points of sale of financial instruments, in order to evaluate the compliance of internal control and IT system operations.

Regarding the supervision of the central securities depository Nasdaq CSD SE, the FCMC carried out off-site measures related to the evaluation of the statements, reports and other information submitted by the central securities depository, but within the framework of the supervision several meetings with Nasdaq CSD SE representatives took place as well. Taking into consideration the fact that the year 2018 was the first full year of the Nasdaq CSD SE activity, the first on-site inspection of Nasdaq CSD SE will be conducted in 2019. Taking into consideration the fact that Nasdaq CSD SE is providing services in Lithuania and Estonia as well, the FCMC, within the framework of the Nasdaq CSD SE supervisory college, cooperates closely with Lithuanian and Estonian supervisory authorities and central banks, as well as with the Bank of Latvia.

In 2018, no violations of legal acts regulating their activities were identified in the activities of the points of sale of financial instruments. With regard to the Nasdaq CSD SE activity the FCMC established an infringement related to the fact that in the case of one IT incident Nasdaq CSD SE could not provide major services of the central securities depository for a period of longer than two hours in all three securities settlement systems (Latvian, Lithuanian and Estonian) supported by Nasdaq CSD SE. Taking into consideration the fact that the actual effect caused by the incident on the securities settlement systems was not considerable, as a sanction the FCMC issued a public notification about the infringement allowed.

Activities of issuers of the financial instruments listed on the regulated market and supervisory measures applied thereto

During 2018, the regulated market (Stock Exchange) stock list was left by four issuers, and at the end of the year in total the stocks of 19 joint stock companies (issuers) were listed on the Stock Exchange, out of which the stocks issued by four issuers were listed on the Official Listing and the stocks of 15 issuers – on the Second Listing. The bonds of one new issuer were included in the securities listing in 2018, and, at the end of the year, in total it included the issues of 42 various debt securities in a total of 13 issuers, whereof nine issues were Latvian government debt securities and 33 issues were corporate debt securities.

The task of the FCMC is to supervise whether the issuers are disclosing the regulated information in due time and in accordance with the requirements of the FIML and Regulation No. 596/2014. In carrying out the aforementioned supervision, in the reporting year it was followed closely, whether every issuer had published financial statements (both audited annual and interim) in a timely manner and in accordance with the requirements of the law, and the FCMC acted so that the issuer eliminated the identified deficiencies. In total, in 2018 the FCMC sent eight letters of reprimand to the issuers. Administrative proceedings were instigated against the issuers, whose infringements with respect to publishing the regulated information, including financial statements, had been material, protracted or repeated, and in three administrative proceedings decisions were adopted on the infringements of the FIML imposing a fine on the relevant companies (in the amount of EUR 1,000, EUR 5,000 and EUR 10,000).

In carrying out the off-site enhanced inspections of the financial information (statements) prepared by issuers, it was monitored whether issuers had observed the requirements for the preparation of the statements, but significant deficiencies or violations in statement preparation were not identified. Correspondence on individual financial statements was conducted with individual issuers, so that the identified discrepancies were eliminated in the subsequent statements.

To facilitate the protection of investor interests, as well as to promote the actions of the market participants in accordance with the norms of law, in 2018 the FCMC also continued the practice launched in previous years to take informative measures (seminars and informative letters), by informing the issuers on the coming into effect of the new requirements, explaining the application of requirements of separate legal acts, as well as directing the attention of the issuers to the most frequent deficiencies.

Securities traded in the multilateral trading system

At the end of 2018, the stocks of three joint stock companies were listed in the multilateral trading system First North Latvia, of which one company was listed as a new issuer in 2018. 2018 was the first year when debt securities were also listed for trade on First North Latvia – bonds of two issuers were included in the debt securities list of First North Latvia.

The alternative market does not have the status of the EU regulated securities market. The enterprises listed on First North Latvia market are bound by the regulations of First North Latvia, and they are not subject to the requirements prescribed for the enterprises listed on the regulated market (including requirements on the disclosure of regulated information), which are usually stricter.

Trading in financial instruments (on the regulated and alternative market) and the supervision of investor activities

In 2018, in the Latvian regulated market – Stock Exchange – a significant decrease in the activity of trading in stock was observed, as compared to the year before, which can be explained by the fact that in 2017 58.2% of the total stock turnover accounted for the transactions with the stocks of AS Latvijas Kuģniecība that was related to the mandatory stock redemption offer expressed by the majority stockholder. The total number of transactions in the stock market decreased by 27.3% in 2018 compared to 2017. The total turnover in the stock market was EUR 14.0 million in 2018, which was 71.7% less than in 2017. At the end of 2018, the stock market capitalisation of the Stock Exchange, compared to the end of 2017, had dropped by 39.6% and comprised EUR 752.3 million.

Trading activity on First North Latvia increased significantly in 2018, which is mainly related to the transactions made with the stocks of SIA Madara Cosmetics – the total stock turnover of First North Latvia accounted for EUR 5.8 million in 2018, which, compared to the turnover of 2017, was more than 23 times higher.

The task of the FCMC is to supervise trading in financial instruments with the aim to identify and prevent market manipulation and insider dealing, thus fostering the stability of the financial instruments market and transparency of its operations. The FCMC continuously carried out supervision by following the transactions closed by the shareholders and bondholders, and analysed the purchase and sales orders submitted to the Stock Exchange, as well as to First North Latvia. In 2018, the FCMC also received and analysed 17 reports from market participants about suspicious transactions with financial instruments. In several cases the FCMC requested explanations by investors in relation to the submitted orders and transactions performed, as there were features identified indicating market manipulation or insider dealing. In six cases due diligence was carried out. In two cases, the FCMC carried out the corrective measures by sending a letter of reprimand and indicating to the investor that signs of market manipulation had been observed in its transactions performed, and required it to immediately cease the actions that might mislead other investors regarding stock price, demand and supply. In 2018, the FCMC applied sanctions to two persons about market manipulation in the administrative case that had been started in 2017, imposing a fine on one person in the amount of EUR 1,000 and a public announcement about the violation allowed as a sanction on the other person.

Likewise, the FCMC regularly supervised whether the information on changes in a significant holding (5% and more) was disclosed, whether the threshold of the holding was reached, which would create a duty to express the mandatory stock redemption offer, as well as whether the persons carrying out management duties, or the persons closely related to them according to the requirements of Regulation No. 596/2014, had reported their transactions performed with issuer's securities. In several cases the FCMC corresponded with persons to clarify the submitted and published notifications, ensuring the availability of full and precise information to other participants of the financial and capital markets. A letter of reprimand was sent to one person on non-observance of the deadline regarding manager notifications according to the requirements of Regulation No. 596/2014. In one of the administrative cases initiated by the FCMC, violations were identified in relation to the notification about significant holding, the submission of managers' notifications and the non-expression of the mandatory stock redemption offer. In the aforementioned administrative case, the FCMC concluded an administrative agreement, imposing a fine on persons in the amount of EUR 131,250.

SUPERVISION OF COMPLIANCE

In the field of AML/CTF, in 2018, the work started in the previous years was actively continued for the improvement of the regulatory framework, as well as the supervisory processes of compliance with AML/CTF requirements for banks and non-bank financial institutions, as well as in the strengthening of the AML/CTF supervisory function carried out by the FCMC.

Ensuring the introduction of recommendations of the Financial Action Task Force (FATF) and suggestions by the experts of the Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism of the Council of Europe Moneyval, as well as in order to strengthen the financial system by reducing the number of high risk exposures with particularly high risk clients that are shell arrangements and match certain characteristics, and to promote information exchange between the subjects of AML/CTF Law and law enforcement institutions for combating financial crimes, the FCMC participated in the development of the amendments to the AML/CTF Law. With these amendments a prohibition was laid down on credit institutions, payment institutions, investment firms and regarding the management of individual portfolios of clients and also the distribution of certificates of open-end investment funds to investment management companies to cooperate with shell arrangements or shell companies that simultaneously comply with two characteristics determined by the Law, i.e. firstly, has no affiliation of a legal person to an actual economic activity or the operation of a legal person forms minor economic value or no economic value at all, and the subject of the Law has no documentary information at its disposal that would prove the contrary, and secondly, laws and regulations of the country where the legal person is registered do not provide for an obligation to prepare and submit financial statements for its activities to the supervisory institutions of the relevant state, including the annual financial statements. In addition, in 2018, the FCMC participated in the development of the amendments to the Law on International Sanctions and National Sanctions of the Republic of Latvia, that specify the range of subjects covered by the compliance and fulfilment of sanctions, address the issue related to the time of coming into force of national sanctions and the action of the order of the Cabinet of Ministers in the case of its contestation, as well as the issue of sanction application in the field of public procurement. The amendments also determine the rights of the competent authorities to take a decision on the imposition of fines, if the regulation of the Law is broken, as well as separate the imposition of these fines from the regulation of the Criminal Law.

Taking into consideration the delegation determined by the AML/CTF Law, the FCMC issued the normative regulations of enhanced customer due diligence to credit institutions and licensed payments institutions and electronic money institutions, as well as the normative regulations of enhanced customer due diligence binding on private pension funds, investment firms, investment management companies, registered payment institutions and electronic money institutions whose activities do not require a licence. Taking into consideration the amendments made to the AML/CTF Law, the FCMC supplemented the normative regulations of enhanced customer due diligence with the minimum requirements that should be performed by an institution to check whether the client – a shell arrangement – has affiliation to an actual economic activity or its operation forms a minor economic value or no economic value at all, and whether the subject of the Law has documentary information at its disposal that would prove the contrary. In addition, the FCMC participated in the development of the Regulations of the Cabinet of Ministers determining the procedures and scope by which the subject of the AML/CTF Law performs remote identification of a customer.

Taking into consideration the delegation determined in the Law on International Sanctions and National Sanctions of the Republic of Latvia the FCMC issued recommendations to credit institutions, licensed payment and electronic money institutions and their branches in Member States and third countries to reduce the risks associated with the failure to comply with sanctions in order to promote the aforementioned Institutions' understanding of the measures to be implemented in compliance with the requirements of international and LR national sanctions.

At the same time, the FCMC continued its regular monitoring in the AML/CTF prevention area, and as a result in 2018 a fine was imposed on three credit institutions for the failure to comply with the requirements laid down in the AML/CTF prevention law, to a total of EUR 3,907,902, as well as a set of duties was imposed that should be carried out in order to fine-tune and improve the internal control systems of the credit institutions. The FCMC carried out the follow-up supervision of the fulfilment of these obligations. In addition, in one case a reprimand was issued to the board member responsible for AML/CTF and the said person was dismissed from carrying out duties in the AML/CTF field. In turn, the ECB withdrew the licence of one credit institution.

The FCMC continued the regular supervision in the field of AML/CTF in the non-bank sector as well, as a result of which in 2018 two electronic money institutions and two payment institutions had a fine imposed due to non-observance of the AML/CTF Law requirements in the sum total of EUR 113,255. In addition, in two cases the provision of payment services was suspended, in three cases a reprimand was issued to the AML/CTF responsible persons and in two cases responsible persons were dismissed from carrying out job duties.

In 2018, concerning the issues of the prevention of money laundering the FCMC representatives participated in the work of the Committee of Experts on the Evaluation of Anti-Money Laundering Measures Moneyval of the Council of Europe, as well as participated in the execution of the tasks set by the "Action Plan for the Prevention of Money Laundering and Terrorist Financing for the Time Period until 31 December 2019" approved by the Cabinet of Ministers. In addition, a member of the FCMC, who is included in the Committee for Control of Goods of Strategic Significance operating within the Ministry of Foreign Affairs, participated in the meetings of this committee in 2018.

In accordance with the FCMC's register of unusual and suspicious financial transactions, in 2018, 30 reports were sent to the Office for the Prevention of Laundering of Proceeds Derived from Criminal Activity.

SECURITY OF FINANCIAL SERVICES AND INFORMATION SYSTEMS

In 2018, the FCMC carried out on-site information system security audits in three banks, one insurance company, one credit union and one payment institution. Within the SSM, the FCMC also took part in one on-site inspection on IT risks organised by the ECB. Increased attention was paid to the security of the provision of remote services, cybersecurity and ensuring business continuity. Considerable effort was made for the registration and licensing of the applications of new services of market participants and applications of new market participants, by assessing the conformity thereof to the requirements of statutory regulations on information systems.

Ensuring the fulfilment of the LPSEM requirements on the security measures regarding operational and security risks of payment services, changes to the Information System Security Normative Regulations were made, and Normative Regulations on Major Incident Reporting Related to Payment Services were developed.

In 2018, the FCMC consulted market participants on the requirements of the LPSEM regarding payment security, including strict authentication by using remote payment services, and provided consultations about the requirement of the LPSEM for payment services providers to ensure access to client accounts by third-party service providers.

REVIEW OF CUSTOMER COMPLAINTS ON THE ACTIONS OF MARKET PARTICIPANTS

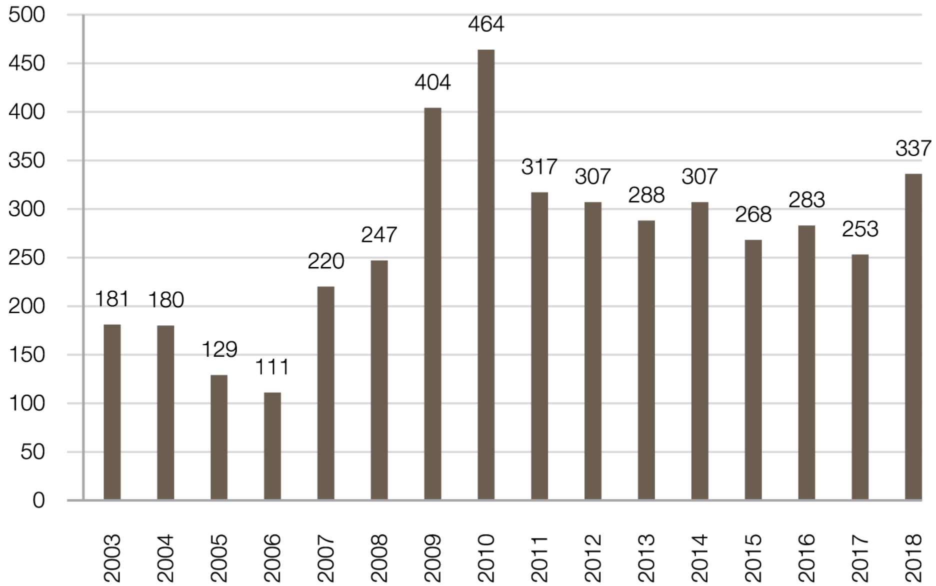
The protection of the rights of the clients of market participants and the reviewing of complaints of the actions of market participants was also one of the parts of the FCMC supervision in 2018.

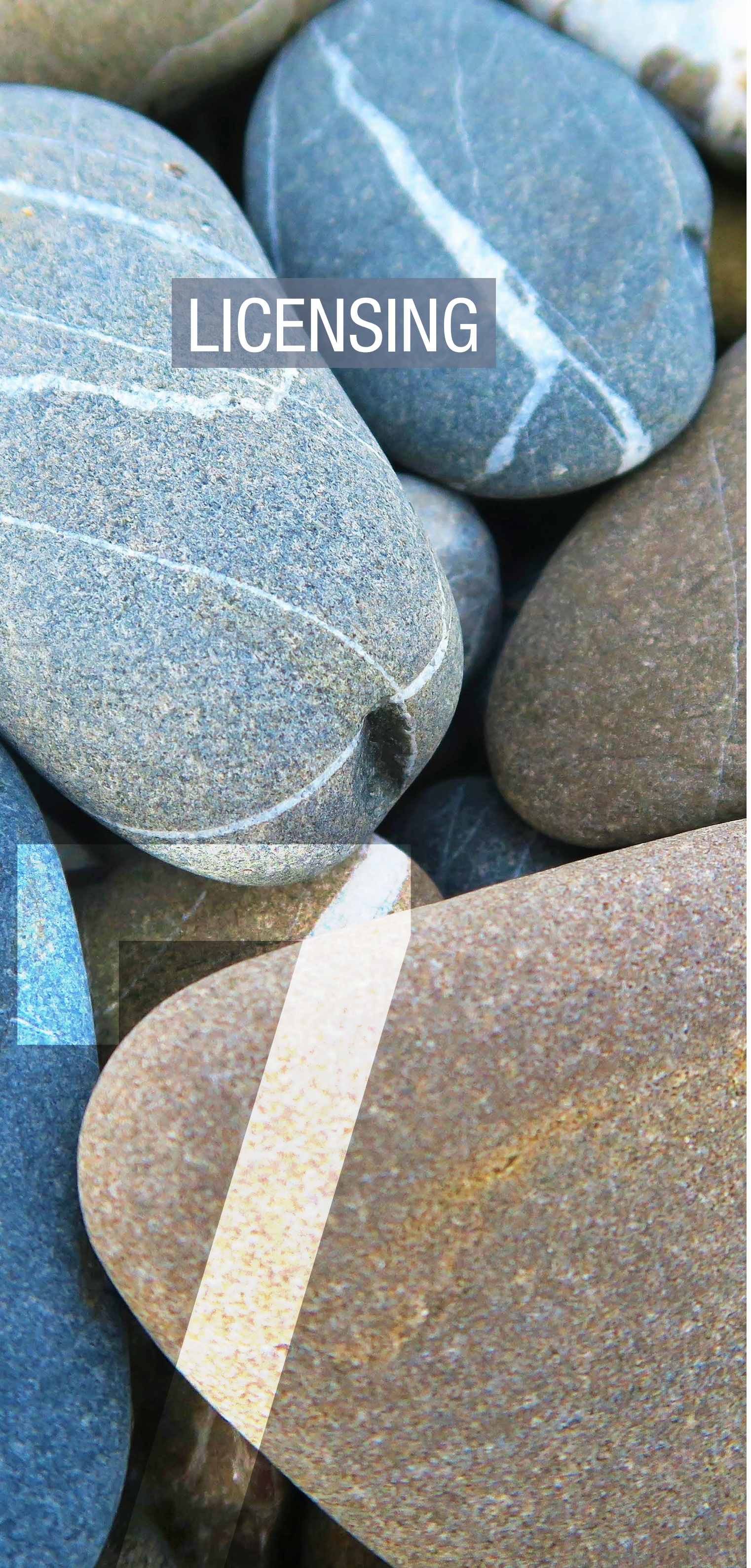
In 2018, the FCMC received and reviewed 336 complaints regarding the actions of financial and capital markets' participants – 290 complaints on credit institutions, 34 – on insurance companies, five – on payment institutions and electronic money institutions, while seven complaints – on market participants providing investment services.

Taking into account the fact that within the process of supervision of credit institutions it is being controlled, whether the credit institutions meet the requirements of the Credit Institution Law and the laws and regulations subordinated thereto, FCMC experts verified whether the actions of the credit institutions have the features of violations of these laws and regulations. Having reviewed 284 complaints, the FCMC did not identify any violations of the Credit Institution Law and the laws and regulations subordinated thereto in the actions of the credit institutions, but the information provided in complaints is used for supervisory purposes. Having reviewed that which was mentioned in six complaints, deficiencies were identified in the management of operational risk at the relevant credit institutions.

In 2018, the FCMC received and reviewed 35 applications on the actions of insurance market participants in total – 19 applications on insurance companies, 13 – on the branches of EU Member State insurers in Latvia, two on several insurers and one – on the insurance and reinsurance intermediary actions. In all cases, the FCMC asked the market participants to provide explanations, after the assessment whereof, the FCMC provided answers or advice on its merits to the clients, within the scope of the FCMC competence. Having reviewed 35 complaints of the clients of insurers and insurance and reinsurance intermediaries, the FCMC did not detect any violations of the laws and regulations, which would be subject to the imposition of sanctions prescribed by the Insurance and Reinsurance Law or the Law on the Activities of Insurance and Reinsurance Intermediaries.

Figure 22
Number of received complaints





LICENSING

In 2018, minor changes could be observed in all segments of the financial market. In bank licensing the started merger project of Luminor Bank continued at the Baltic level, as a result of which the licence of Luminor Bank AS was withdrawn and as of 2 January 2019 the bank continued its activities in Latvia as a branch of Estonian Luminor Bank AS. Likewise, in 2018 the ECB took a decision to withdraw the licence of ABLV Bank, taking into account the fact that the bank had started the self-liquidation process. The ECB also passed a number of decisions regarding the granting of qualifying holding and the approval of the appointment of significant officials to credit institutions. The FCMC has continued to be actively involved in this process, still being the authority responsible for examining the submitted documents and for preparing a draft decision, which is subsequently submitted to the ECB for final decision-making.

In 2018, within the reorganisation process of the Luminor group the reorganisation of Luminor Pensions Latvia IPAS was also finished by way of merging commercial companies, by merging Luminor Pensions Latvia IPAS to Luminor Asset Management IPAS.

In 2018, changes also took place in the credit union sector. The FCMC issued two licences – to the cooperative credit union Metsepole and the cooperative credit union Savstarpējā CKS. In turn, the licence of the cooperative credit union Latvijas Lauksaimnieku krājaizdevu sabiedrība was withdrawn.

In 2018, the licence of AS Alpari Europe IBS, which eventually had not started its activities, was withdrawn.

In 2018, registration of seven payment institutions was cancelled, and these changes were mainly related to the willingness of the companies to restructure their activity, whereas in some cases the cancellation was related to the identified long-term breaches of laws and regulations.

During the reporting year, four AIFM were registered.

Table 1
Changes in the number of licensed market participants in 2018

	At the beginning of 2018	At the end of 2018	New market entrants in 2018
Banks	16	14 (-2 banks)	0[1]
Branches of EU Member State banks	5	5	0[2]
Cooperative credit unions	33	34 (-1 company)	+2[3]
EEA-based providers of banking services	353	358 (-10 banks)	+15
Insurance companies	6	6	0
Branches of EU Member State-based insurers	11	11	0
EEA-based providers of insurance services	531	546 (-16 companies)	+31
Investment management companies	12	11	-1[4]
EEA-based providers of investment management services	21	29	+8

[1] Banks:
On 11 July 2018, the ECB takes a decision to withdraw the licence of *ABLV Bank*.
On 27 December 2018, the ECB takes a decision to withdraw the licence of Luminor Bank AS **(the licence was withdrawn on 2 January 2019)**. By way of reorganisation Luminor Bank AS is merged to Luminor Bank AS (Estonia) on 7 January 2019.

[2] The branches of EU Member State-based banks:
On 2 January 2019, after reorganisation Luminor Bank AS Latvia Branch starts activity in Latvia.

[3] Cooperative credit unions:
On 3 July 2018 the licence of cooperative credit union *Latvijas Lauksaimnieku krājaizdevu sabiedrība* was withdrawn.
On 30 October 2018 a licence was issued to the cooperative credit union Metsepole.
On 9 November 2018 a licence was issued to the cooperative credit union *Savstarpējā CKS*.

[4] Investment management companies:
On 2 August 2018, the reorganisation of Luminor Pensions Latvia IPAS was finished by way of merging commercial companies, by merging Luminor Pensions Latvia IPAS to Luminor Asset Management IPAS.

	At the beginning of 2018	At the end of 2018	New market entrants in 2018
Investment firms	5	5	0[5]
EU Member State-based investment firms	1	1	0
EEA-based providers of investment firm services	2,034	2,115 (-34 companies)	+115
Agents engaged by the EEA-based providers of investment services	37	37 (-9 companies)	+9
Private pension funds	6	6	0
Insurance brokerage firms	80	71 (-9 companies)	0[6]
Insurance agents	459	421 (-45 agents)	+7
EEA-based providers of payment services	362	384 (-31 companies)	+53
Payment institutions (registered)	19	12 (-7 companies)	7[7]

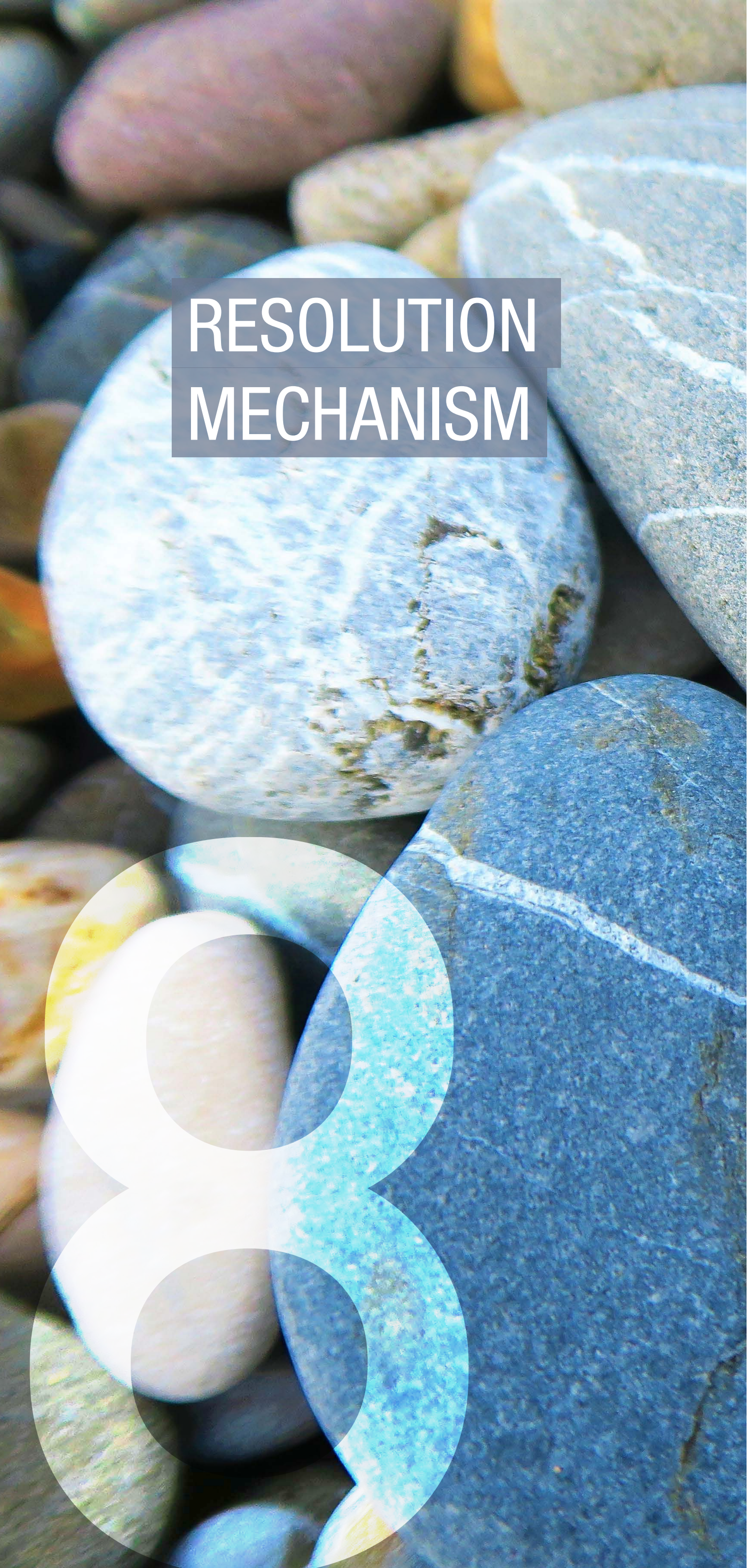
[5] Investment brokerage companies:
On 8 January 2019 the AS Alpari Europe IBS licence was withdrawn.

[6] Insurance brokers:
Entry in the register withdrawn about: SIA *Apdrošināšanas aģentūra 777*, SIA *BA Root*, SIA Balto Link (reorganisation by way of cross-border merger), SIA *BB Brokeris*, SIA *Dzīvības Apdrošināšanas Brokeri*, SIA Finance & Insurance Brokers, SIA Globale Insurance, SIA Marko Brokeri, SIA Money Express Brokeris.

[7] Payment institutions:
Entry in the register withdrawn about: SIA *PayB*, SIA Bilderlings Pay, SIA WPS, SIA Transferta, AS *Komunālo maksājumu centrs*, SIA TransferMoney, SIA Narvesen Baltija.

	At the beginning of 2018	At the end of 2018	New market entrants in 2018
Payment institutions (licensed)	3	3	0
Electronic money institutions (registered)	10	10	0
Electronic money institutions (licensed)	3	3	0
EEA-based electronic money institutions	153	194 (-6 companies)	+47
Licensed AIFM	7	7	0
Registered AIFM	10	14	+4[8]

[8] Registered AIFM:
On 10 October 2018, the alternative investment fund manager was registered – SIA 2B Capital AIFP.
On 29 May 2018, the alternative investment fund manager was registered – SIA AIFP Buildit Latvia.
On 10 July 2018, the alternative investment fund manager was registered – SIA Commercialization Reactor Fund AIFP.
On 24 April 2018, the alternative investment fund manager was registered – SIA Overkill Ventures AIFP.



THE PRINCIPLES OF THE RESOLUTION MECHANISM

The principles of the resolution mechanism

One of three banking stability pillars – a resolution mechanism has been established according to the BRRD.

The main objectives of the introduction of the resolution mechanism are as follows:

- To set a uniform approach and effective instruments throughout the entire EU, to timely prevent the consequences related to the banking crisis;
- To protect the stability of the financial system and ensure the continuity of critically important functions;
- To considerably minimise the possibility of tax payers incurring losses, by requiring that the expenses for rescuing a bank that is important to the national economy are covered by the shareholders and creditors of the bank;
- To establish an effective cross-border banking group resolution mechanism.

The institution in charge of resolution in Latvia is the FCMC, and it is responsible for the preparation of resolution plans, as well as for carrying out resolution activities or the rescuing of such institutions, the resolution whereof is required in the interests of the general public, or for decision-making on non-application of the resolution.

The resolution mechanism is also applicable to the investment brokerage firms, subject to the minimum equity requirement in an amount of EUR 750,000.

The Regulation of the European Parliament and of the Council establishing the Single Resolution Mechanism came into force on 1 January 2016.

SINGLE RESOLUTION MECHANISM

Taking into account the fact that Latvia is a Eurozone country, it automatically obtains the status of a member state of the SRM. An SRB has been established, which, in cooperation with the involved national resolution authorities of the EU Member States (including the FCMC), implements efficient and coordinated functioning of the SRM, and is responsible for the management and use of the funds of the SRF, as well as for the performance of the functions of the resolution authority with respect to banks falling under the direct competence of the SRB.

The objective of the SRF is to ensure financial resources which, in the case of crisis, can be used to finance the resolution of the bank. The SRF is financed from the contributions of the Member States' banks (including Latvian banks), aimed at gradually achieving (by 2024) an amount comprising 1% of the covered deposits in all credit institutions in all involved Member States.

The SRB carries out the functions of a resolution authority over Latvian banks which are subject to direct supervision by the ECB within the scope of the SRM, whereas the FCMC prepares the SRB decisions and implements the adopted decisions. In 2018, three (in 2017 – four) Latvian banks were subject to direct SRB resolution. On 23 February 2018, after the adoption of the ECB decision about the announcement of ABLV Bank as a bank failing or likely to fail the SRB took a decision that the implementation of the resolution for ABLV Bank is not justified. When assessing the activities of the bank and the nature of the problem, it was identified that it is impossible to carry out measures in the private sector that could prevent the financial difficulties of the bank, the bank does not perform critical functions and the bank does not have a significant impact on the financial system of Latvia. Therefore, the resolution of the bank is not in line with the interests of the public and the bank should be liquidated according to the legal norms of Latvia.

Decision-making regarding the application of the resolution to another 12 Latvian banks falls within the competence of the FCMC.

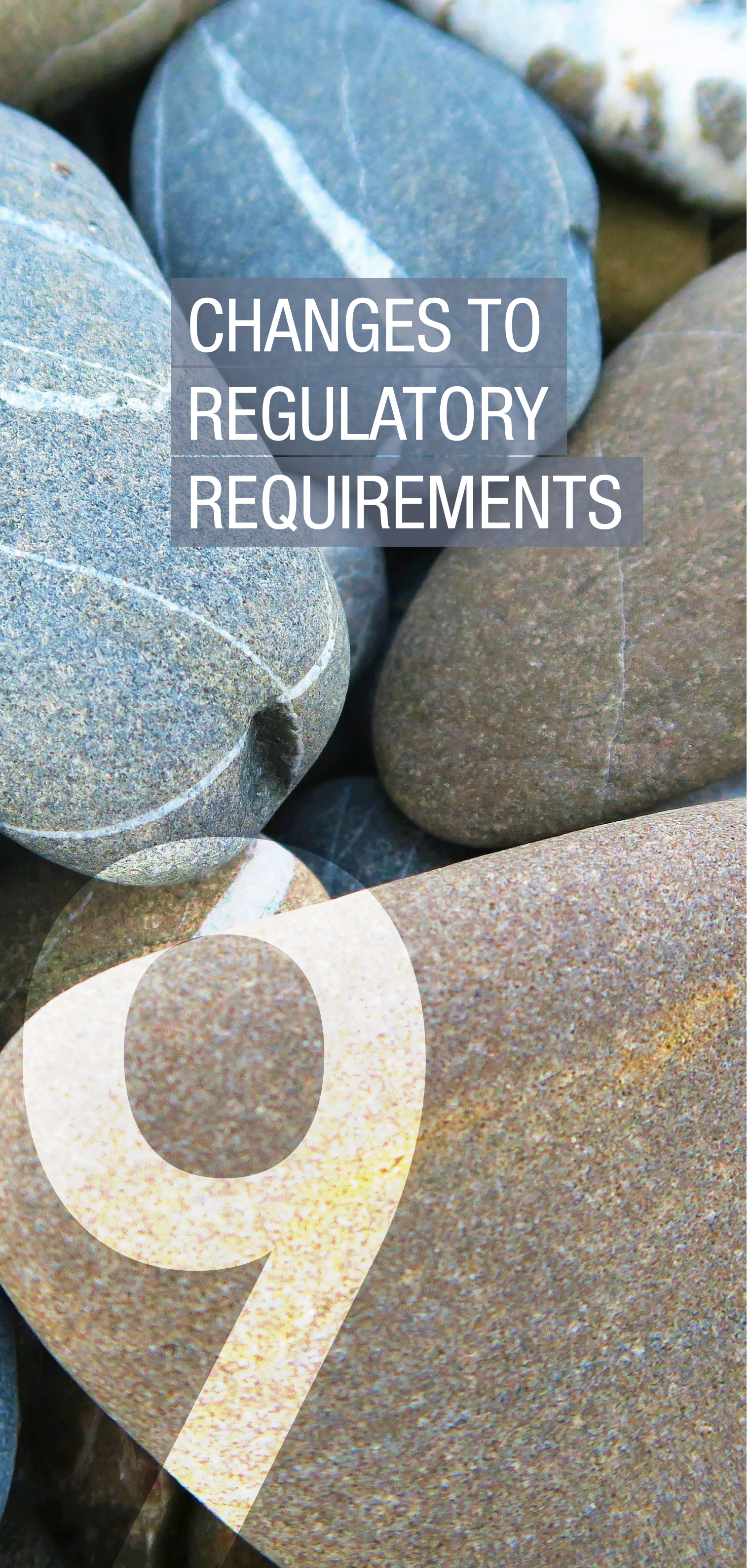
To ensure the effective resolution of such banking groups, which are engaged in cross-border operations, resolution colleges have been set up within the EU, engaging experts of the FCMC in the activities thereof.

2018 was already the third year that the FCMC participated in the implementation of the SRM. Based on the experience of the previous years, in the reporting year more attention was paid to the more detailed development and improvement of resolution plans. According to the SRB policy, the role of national resolution institutions (including the FCMC) increased significantly in the development of resolution plans of the banks falling within the direct competence of the SRB. In 2018, the FCMC resolution experts took active part in the development process of the resolution plans for the Latvian banks falling within the direct competence of the SRB. In-depth assessment was carried out on the more appropriate resolution instruments for each bank and on operational steps for their application. In 2018, developing resolution plans for banks according to the SRB methodology; for the first time the minimum requirements for own funds and eligible liabilities were determined at the consolidation level, which is one of the main resolution instruments.

Also, the FCMC continued the work on the development of resolution plans for other banks falling within direct competence of the FCMC. In 2018, four (out of 10) resolution plans were developed.

CRISIS MANAGEMENT

One of the key tasks of the FCMC is to be prepared to act immediately in response to a crisis of an individual bank or the financial system. Therefore, in 2018 the FCMC also continued to improve its internal processes, which ensure proactive and immediate action of the FCMC management and the involved employees in the crisis situation. After careful assessment of the previous experience of addressing crisis situations (AS Trasta Komercbanka, ABLV Bank), the subject-matter experts of the FCMC make the necessary changes in internal regulatory documents regulating the measures of crisis situation prevention. In this field, the main task of the FCMC is to identify problems in the bank's activities in a timely manner, to implement the measures that may prevent the problems, and with the recovery measures foreseen by the bank itself or with the resolution tools to resolve the bank's operations, if it lies in the public interest; however, if it is not possible, to ensure the liquidation of the bank and starting of the depositors' protection system foreseen by the laws and regulations.



9 CHANGES TO REGULATORY REQUIREMENTS

NATIONAL LAWS AND REGULATIONS

In 2018, the FCMC continued to improve the legal framework governing the activities of the participants of the financial and capital markets. The changes in the framework of regulatory requirements were mainly based on the legal acts issued by the EU institutions in order to ensure a harmonised framework in the EU single financial market. In general, broad changes to the regulatory framework were not introduced in 2018.

The amendments approved in 2018 to the **Normative Regulations on Prudential Requirements for the Application of Options and Transition Periods Laid Down in the Directly Applicable Legal Acts of the European Union** determine the transition period in relation to the application of restrictions of large exposures for the Central governments of the Member States, central banks, public sector companies, as well as regional municipalities or local authorities, which are considered to be exposures with the central government that are denominated in the currency of any other Member State and which according to the version of Article 495(2) of Regulation (EU) No. 575/2013, being in force on 31 December 2017, would be assigned the risk weight 0% and which were incurred on 12 December 2017 or later.

In the transition period from 1 January 2018 to 31 December 2020 the institution (a credit institution and an investment firm within the meaning of Regulation No. 575/2013 may undertake the aforementioned exposures, without exceeding the following restrictions:

1) 100% of Tier 1 equity of the institution by 31 December 2018;

2) 75% of Tier 1 equity of the institution by 31 December 2019;

3) 50% of Tier 1 equity of the institution by 31 December 2020.

As of 1 January 2021, the aforementioned exposures will be applied the restrictions laid down in Clause one of Section 395 of Regulation No. 575/2013 (currently it is 25% of the relevant equity of the institution).

Continuing the introduction of the Solvency II regime in the insurance sector, the **Normative Regulations on Solvency Assessment of Insurance or Reinsurance Company Group** were developed, that explain in more detail the application of requirements of Insurance and Reinsurance Law and directly applicable EU normative acts. The regulations replace the regulations previously approved by the FCMC with respect to the calculation of group solvency capital requirement and own funds, preserving the requirements prescribed therein, as well as supplementing them with detailed requirements for separate aspects of the determination of capital adequacy in accordance with that which is stated by the guidelines of the EIOPA.

The FCMC approved the Amendments to the **Normative Regulations on the Preparation of Reports for the Insurers and Reinsurers,** , clarifying the amount of information to be provided in annual and quarterly activity reports submitted for the needs of statistics by insurance companies that have founded branches abroad, as well as the quarterly balance sheet of the branches of Member State insurers for financial statistics needs was simplified and specified.

Taking into account the amendments in the LPSEM, in 2018 the regulations were developed that replaced the previous regulations approved by the FCMC in this field, maintaining the requirements laid down thereof, as well as supplementing them with the procedure on the calculation of own fund requirements for a licensed payment institution, that was laid down in the law so far, and by foreseeing changes in the report preparation and submission procedures and the data reporting format.

Normative Regulations on the Preparation and Submission of Central Securities Depository Supervision Reports, approved in 2018, lay down the information which is disclosed by central securities depositories to the FCMC on the services they provide and their activities, including their supervision reports, that are necessary to supervise the compliance with the requirements laid down in Title I of Regulation No. 2017/390, reports on activities in financial instrument settlement systems that are maintained by central securities depositories, as well as the form and content of these reports, procedure and terms for the provision of this information.

Legal acts adopted in 2018 in the field of AML/CTF and sanctions

On 12 July 2018, the amendments to the Law on International Sanctions and National Sanctions of the Republic of Latvia came into force, improving the mechanism of sanction enforcement. On 9 May 2018, the amendments to the AML/CTF Law came into force restricting the cooperation of financial institutions with shell arrangements. On 15 November 2018 the amendments to the Credit Institution Law came into force regarding the requirements to applicants for working in the financial sector. On 6 July 2018, Regulation of the Cabinet of Ministers No. 392 of 3 July 2018 Procedures by which the Subject of the Law on the Prevention of Money Laundering and Terrorism Financing Performs the Remote Identification of a Customer came into force laying down the procedure by which the subject of the AML/CTF Law performs remote identification by using technological solutions.

In 2018, the amendments of the Commission in the Normative Regulations of Enhanced Customer Due Diligence and Normative Regulations of Enhanced Customer Due Diligence to Credit Institutions and Licenced Payment and Electronic Money Institutions came into force, supplementing them with the measures that should be carried out by a financial institutions regarding the compliance of a shell arrangement to the characteristic features of the prohibited shell arrangement determined by the AML/CTF Law. On 28 June 2018, the Commission's "Recommendations to credit institutions and licensed payment and electronic money institutions to reduce the risks associated with the failure to comply with sanctions" were adopted that explain the duties of financial institutions in the compliance of sanction requirements and give recommendations on the control measures to be taken in order to prevent the financial institutions from engaging in the circumvention of the sanctions.

MACRO-PRUDENTIAL SUPERVISION

Global financial crisis has shown that the micro-prudential supervision, which mainly focusses on ensuring stability at the level of individual financial institutions, is not sufficient to ensure the stability of the financial system as a whole. Therefore, in addition to the previous supervisory approach, new macro-prudential supervision was introduced, providing for taking certain measures, in the case of an increase in cyclical (for example, excessive lending increase) or structural (for example, with respect to the systemically important (too big to fail) credit institutions) risks. In such cases, appropriate macroprudential instruments may be applied, i.e. specified different capital buffer requirements, increased liquidity requirements, and more stringent restrictions on large exposures, etc.

Other systemically important institutions

Under Section 35^9 of the Credit Institution Law, the FCMC identifies credit institutions which qualify as other systemically important institutions (O-SII)[17] once a year, and can set an O-SII capital buffer requirement for them of up to 2% of the total exposure amount. In 2018, the FCMC identified five local financial sector O-SII, whom the O-SII buffer requirements and more rigid requirements in corporate governance were set to (the list is posted on the website of the FCMC). The identified O-SIIs are the same credit institutions that were already identified in 2017, with the exception of one – ABLV Bank – whose licence was withdrawn on 11 July 2018. In turn, as of 2 January 2019 Luminor Bank AS continues its activities as Latvian Branch of the credit institution Luminor Bank AS registered in Estonia, thus the requirements set to O-SSI are no longer applicable to it. Taking into account the decrease of the systemic importance level determined to the banks, it was decided for two credit institutions – AS *SEB banka* and AS *Rietumu Banka* – to decrease their O-SII capital buffer by 0.25 percentage points as of 30

[17] the FCMC carried out the identification of O-SII according to the guidelines by the EBA (EBA/PN/2014/10). The list of globally systemically important credit institutions are identified and published by the Basel Committee on Banking Supervision in collaboration with the Financial Stability Board. Its latest version (16 November 2018) does not contain credit institutions licensed in Latvia.

June 2019. Significant feature of O-SII identification is that it is a preventive measure, to apply a stricter capital buffer and other requirements to the identified O-SIIs, which would henceforth reduce the systemic risk potentially created by the suspension or interferences in the activities thereof. In resolving conduct under crisis circumstances, the systemic significance of credit institutions is to be assessed by other criteria, taking into account the specifics of the crisis and the latest available information about their activities. Therewith, the credit institution, previously identified as O-SII, in a crisis situation may also not receive State aid, if, under relevant circumstances, the potential of the suspension or interferences in the activities thereof to create the systemic risk is evaluated as sufficiently low.

Countercyclical Capital Buffers

The FCMC, as the institution responsible for determining the CCyB reference point, according to Section 35.[5] of the Credit Institution Law, on a quarterly basis, in cooperation with the Bank of Latvia as the macro-prudential authority, analyses the ratio of loan balance and gross domestic product, the deviation of this ratio from the long-term trend, as well as evaluates additional indicators to justify another decision on determination of a CCyB reference point.

The CCyB reference point should be determined to ensure that a credit institution builds up an additional capital base so that it may absorb losses during an economic slowdown or stagnation.

The requirement of the CCyB reference point regarding the transactions with Latvian residents in the amount of 0% came into force on 1 February 2016 for the first time and has remained at this amount henceforth as well.

The FCMC will continue to analyse the relevant indicators and trends, when deciding on the determination of the CCyB reference point in the coming quarters. The FCMC will take a decision on the necessity to determine the CCyB reference point in the amount above 0%, if a significant increase of cyclical systemic risks is observed in the financial sector of Latvia.

EUROPEAN COMMISSION INITIATIVES IN 2018

In 2018 the EC proposed several new initiatives in the field of the development and strengthening of the bank union and capital market union. Active work also continued at the EU Council and European Parliament level at several drafts of legal acts published in previous years. The FCMC experts also took active part in the working groups in the EU Council where during the year 2018 both the new financial sector initiatives and those proposed in previous years were discussed. On several important issues (application of the principle of proportionality, supervision of cross-border banking groups, calibration of macro-prudential instruments), changes in the wording of the original draft legal act were made in line with the interests of Latvia.

In March 2018, the EC made the following legislative proposals:

- Proposal for the European Parliament and Council Regulation on **European collective financing (*crowdfunding*) service provider companies**[18]. The purpose of the proposal is to establish unified rules for crowdfunding at the EU level for small and medium sized enterprises (i.e. they finance projects of legal entities, the amount of which does not exceed EUR 1 million). According to the proposal, a crowdfunding service provider could choose whether to provide or continue to provide services domestically according to the applicable national legal acts (including, if a Member State chooses to apply the MiFID II requirements to crowdfunding activities) or to receive permission to provide crowdfunding services according to the requirements of the proposed regulation;

- Proposal for the Directive of the European Parliament and the Council on the **issue of covered bonds and public supervision of covered bonds** and amending Directive 2009/65/EC and Directive 2014/59/EU and a Proposal for a Regulation of the European Parliament and of the Council on amending Regulation (EU) No. 575/2013 as regards **exposures in the form of covered bonds**[19]. The purpose of the proposal is to ensure that covered bonds are evaluated as a qualitative instrument to which a preferential regime can be further applied in the determination of capital requirements. In the draft legal acts it is proposed to specify the basic elements of covered bonds and determine a single definition, the structural features of the instrument are determined, as well as the duties of competent authorities regarding information publishing in the field of covered bonds;

- Proposal for a Directive of the European Parliament and of the Council amending Directive 2009/65/EC of the European Parliament and of the Council and Directive 2011/61/EU of the European Parliament and of the Council with regard to **cross-border distribution of collective investment funds** and a Proposal for a Regulation of the

[18] https://eur-lex.europa.eu/legal-content/LV/TXT/?uri=CELEX:52018PC0113

[19] https://eur-lex.europa.eu/legal-content/LV/TXT/?uri=CELEX:52018PC0094 un https://eur-lex.europa.eu/legal-content/LV/ALL/?uri=CELEX:52018PC0093

European Parliament and of the Council on **facilitating cross-border distribution of collective investment funds** and amending Regulations (EU) No. 345/2013 and (EU) No. 346/2013[20]. The purpose of the proposal is to reduce regulatory barriers, which are holding back the cross-border distribution of investment funds in the EU, reducing the costs of fund managers in relation to carrying out cross-border activities and facilitating cross-border marketing of investment funds;

- Proposal for a Regulation of the European Parliament and of the Council on amending Regulation (EU) No. 575/2013 as regards **minimum loss coverage for non-performing exposures**[21]. The proposal foresees the duty for banks to accrue adequate resources as soon as new loans become non-performing; therefore, addressing the issues of non-performing loans already at an early stage and preventing the excessive accrual of such amount of loans;

- Proposal for a Directive of the European Parliament and of the Council on credit servicers, **credit purchasers and the recovery of collateral**. The proposal foresees the development of secondary market of non-performing loans, harmonising the requirements and creating a single market for loan servicing and for bank loan transfer to third parties across the EU territory. The other section of the proposal is dedicated to the enforced disposal of the loan collateral in accelerated extrajudicial procedures within which banks and borrowers may agree in advance on an accelerated mechanism for recovering the value of the covered loans;

- Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EC) No. 924/2009 as regards certain **charges on cross-border payments in the Union and currency conversion charges**[22]. The purpose of the proposal is to ensure to the inhabitants and companies in the Member States, that are not participants of the Eurozone, benefits from the regulation on cross-border payments, and to reduce the costs for cross-border transactions in euro currency within the EU significantly.

In turn, in May 2018, the EC published three proposals in the field of **sustainable financing**[23], so that the EU financial sector could undertake the leading role towards a neutral, more effective in terms of resources and more sustainable circular economy, as well as initiated new rules to **ensure better access to financing for small and medium sized enterprises**[24].

From previous years the negotiations were continued in the EU Council with respect to the draft directive and regulation on the **prudential supervision requirements for investment firms**, the **establishment** of the European **deposit insurance system**, as well as regarding the proposal for the regulation on the establishment of a regime for activity recovery and resolution of the central counterparties.

Also, in the EU Council discussions continued on the amendments to the **framework for the capital requirements and recovery activities and resolution of credit institutions** and on the proposal for a Regulation of the European Parliament and of the Council on **pan-European private pension product**, which was agreed on in December 2018 by a trialogue agreement.

Also, the negotiations on a legislative package for the **revision of the European System of Financial Supervision** entered the final phase, which, in September 2018, was supplemented by the EC proposal in the field of combatting money laundering by providing EBA with new functions in the field of AML/CTF.

2018 was not productive in the adoption of new first level legal acts in the field of financial services. A directive was approved and published in the field of **prevention of money laundering and terrorist financing** – Directive (EU) 2018/843 of the European Parliament and of the Council of 30 May 2018 amending Directive (EU) 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, and amending Directives 2009/138/EC and 2013/36/EU[25].

Concurrently, a number of delegated and implementation regulations of the EC have been adopted during 2018, laying down the technical standards for the application of certain previously adopted EU norms of law, including for the implementation of CRR/CRD IV, Solvency II, PSD2, MiFID II, MiFIR, etc. first-level legal acts. The relevant legislation is published on the FCMC website http://www.fktk.lv/lv/tiesibu-akti/jaunumi.html in breakdown by market segment.

[20] https://eur-lex.europa.eu/legal-content/LV/TXT/?uri=CELEX:52018PC0092 un https://eur-lex.europa.eu/legal-content/LV/TXT/?uri=CELEX:52018PC0110

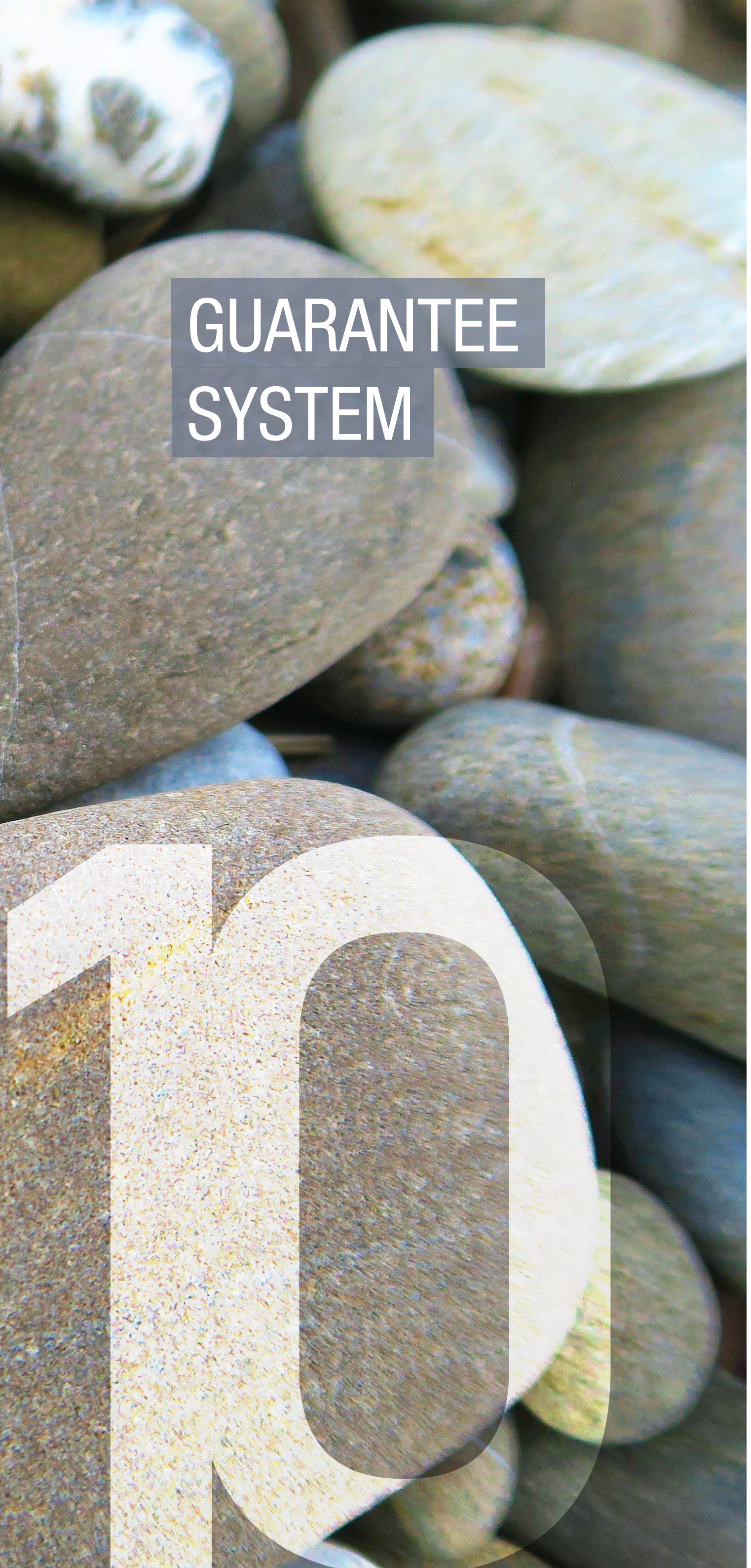
[21] https://eur-lex.europa.eu/legal-content/LV/TXT/?uri=CELEX:52018PC0134

[22] https://eur-lex.europa.eu/legal-content/LV/TXT/?uri=CELEX:52018PC0163

[23] https://ec.europa.eu/info/publications/180524-proposal-sustainable-finance_en

[24] https://ec.europa.eu/info/publications/180524-proposal-sme-market-abuse-prospectus_en

[25] https://eur-lex.europa.eu/legal-content/LV/TXT/?uri=CELEX:32018L0843



GUARANTEE SYSTEM

The structure of financial stability in Latvia is composed of:

1. The Deposit Guarantee Fund;
2. The Fund for the Protection of the Insured;
3. The protection system of the customers of the financial instruments market (investors);
4. The financial stability fee.

DEPOSIT GUARANTEE FUND

The guaranteed compensation for depositors of Latvian banks and credit unions (deposit-takers) (with certain exceptions provided for in Section 23 of the Deposit Guarantee Law) has been set at EUR 100,000 per deposit-taker. In the cases specified in Section 4 of the Deposit Guarantee Law, the guaranteed compensation has been set at EUR 200,000.

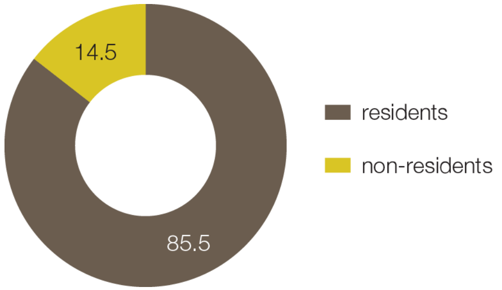
The State guarantees compensation specified in the Deposit Guarantee Law to each deposit-taker irrespective of whether there are sufficient funds in the DGF at the particular time. Under the Deposit Guarantee Law, in cases when the funds are not sufficient, they would be provided by borrowing them from a bank registered in Latvia or the Latvian branch of a foreign bank; however, if the funds are still not sufficient, by borrowing from the Treasury. For the purposes of managing risks, if the DGF has to commence the disbursement of guaranteed compensation within the term set by the Deposit Guarantee Law and if the funds of DGF are not sufficient, the FCMC has developed the procedure under which it concludes the loan agreements on borrowing of the missing amount.

Table 2
Deposits of Latvian deposit takers as at 31 December 2018

	Amount	Share, %
Total number of depositors	2,187,194	100.0
including residents	2,120,497	97.0
including non-residents	66,697	3.0
Balance of covered deposits, in EUR thousand	8,467,664.7	100.0
including residents	7,242,457.9	85.5
including non-residents	1,225,186.8	14.5
Amount paid by the deposit takers into the DGF by 31 December 2018, in EUR thousand	331,512.1	-

The share of the total covered deposit balance amount of Latvian deposit takers (of Latvian credit institutions, excluding credit institution branches in Latvia, and credit unions) at 31 December 2018 is reflected in Figure 23.

Figure 23 The share of covered deposit amount of Latvian deposit takers as at 31 December 2018



Under the Deposit Guarantee Law deposit-takers (banks and credit unions) are required to make a quarterly payment to the DGF amounting to 0.05% of the average balance of covered deposits with the deposit taker in the previous quarter. Additionally, according to the procedures determined in the Deposit Guarantee Law deposit-takers determine the correction coefficient applicable to their covered deposits. When establishing the adjustment ratio applicable to the payment, each deposit taker's capital, liquidity and large exposure indicators are considered, and the loan portfolio quality indicators in the previous calendar year, as well as the business model indicator of the deposit taker. In 2018, the average applicable adjustment ratio applicable to the banks was 119.36%, but to credit unions – 97.95%, meaning that the banks paid in 19.36% more than they would have had to pay of the amount of the covered deposits, while the credit unions – on average, 2.05% less. Deposit-takers paid EUR 17.13 million into the DGF for 2018.

In the reporting period, on 27 February 2018, the FCMC adopted the decision on unavailability of ABLV Bank deposits, providing for the transfer of its monetary funds in the amount of EUR 480 million into the DGF's current account, to ensure the funds for the disbursement of guaranteed compensation to the depositors of ABLV Bank in the amount of the covered deposits. On 2 March 2018, the FCMC entered into an agreement with AS *Citadele banka* in order to secure the disbursement of guaranteed compensation to the depositors of ABLV Bank.

During the reporting year, the FCMC ensured the disbursements of State guaranteed compensation via AS *Citadele banka* (the disbursing bank) to the depositors of AS *Latvijas Krājbanka* in liquidation (hereinafter in this section – *Latvijas Krājbanka* AS in liquidation) and ABLV Bank in liquidation (hereinafter in this section – ABLV Bank AS in liquidation) in the amount prescribed by the Deposit Guarantee Law.

During the reporting year, the guaranteed compensation has been disbursed:

- in the amount of EUR 173.5 thousand to the depositors of *Latvijas Krājbanka* AS in liquidation;
- in the amount of EUR 389,930.9 thousand to the depositors of ABLV Bank AS in liquidation.

The number of depositors of Latvijas Krājbanka AS in liquidation and ABLV Bank AS in liquidation entitled to the guaranteed compensation is reflected in Figure 24.

Figure 24 The number of depositors of *Latvijas Krājbanka* AS in liquidation and ABLV Bank AS in liquidation entitled to the GC broken down by: disbursed and unpaid GCs as at 31 December 2018.

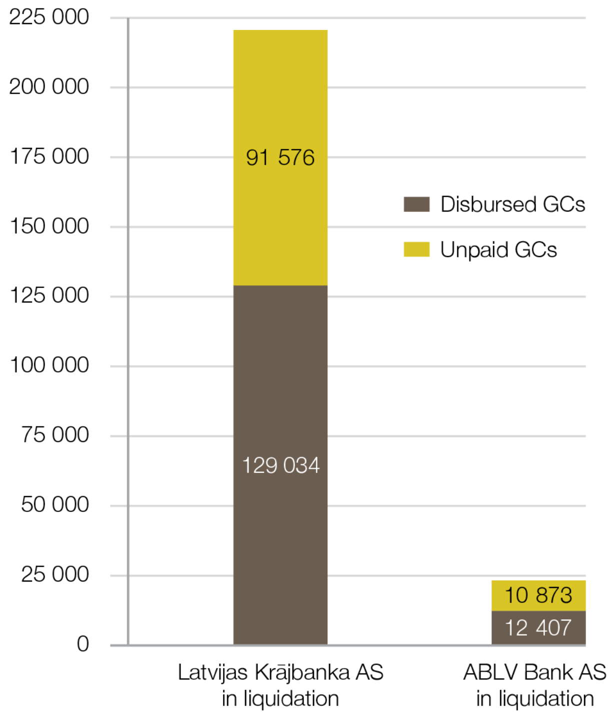
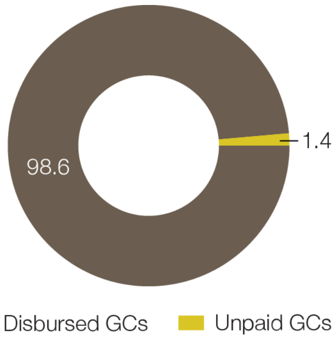


Table 3 Ensuring the disbursement of GC payable to the depositors by 31 December 2018:

	***Latvijas Krājbanka* AS in liquidation**			**ABLV Bank AS in liquidation**		
	number of depositors	amount, EUR thousand	amount share, %	number of depositors	amount, EUR thousand	amount share, %
Rights to GC	220,610	478,814.5	100.0	23,280	486,444.9	100.0
Disbursed GCs	129,034	472,284.9	98.6	12,407	389,930.9	80.2
Unpaid GCs	91,576	6,529.6	1.4	10,873	96,514	19.8

The share of disbursed and unpaid guaranteed compensation amounts to the depositors of *Latvijas Krājbanka* AS in liquidation in the total amount of guaranteed compensation is reflected in Figure 25.

Figure 25
The share of GC amounts of depositors of *Latvijas Krājbanka* AS in liquidation as at 31 December 2018, %



The share of disbursed and unpaid guaranteed compensation amounts to the depositors of ABLV Bank AS in liquidation in the total amount of guaranteed compensation is reflected in Figure 26.

Figure 26
The share of GC amounts of depositors of ABLV Bank AS in liquidation as at 31 December 2018, %

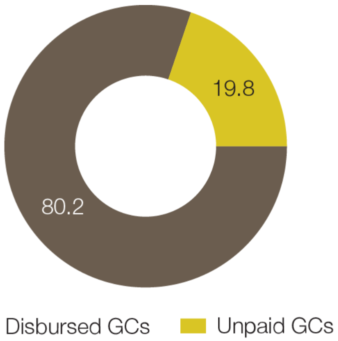


Table 4
DGF accrued liabilities for the GCs to be disbursed, as at 31 December 2018:

Deposit-taker	Accrued liabilities, EUR thousand	Number of depositors
ABLV Bank AS in liquidation	96,514.0	10,873
Latvijas Krājbanka AS in liquidation*	9,130.0	92,586
Ogres komercbanka AS in liquidation	31.0	10
VEF banka AS in liquidation	45.7	54
Insolvent *Raunas Cooperative Credit Union*	0.4	12
Total	105,721.1	103,535

* The accrued liabilities are reflected together with the potential GC that might be recognised as subject to disbursement, but the number of depositors includes the depositors, whom the GC is transferred for disbursement, but they have not applied for the receipt of the GC.

The DGF has the priority right to claim amounts from the banks which are being liquidated (up to the amount of the guaranteed compensation), but in regard to the cooperative credit unions that are under liquidation or insolvent, the DGF has the right of remaining creditors to claim receivables in the amount of the disbursed guaranteed compensation. Notwithstanding the first priority claim rights of the DGF against the bank to be liquidated, the FCMC still has to assess the ability of the bank to be liquidated to sell the assets of the bank and to determine the recoverable value thereof, in order to evaluate its claims in the balance of the DGF. To this effect, there are provisions formed in the DGF in the amount of EUR 199,979.7 thousand, in 2018 forming provision reversal in the amount of EUR 14,000 thousand.

In 2018, the FCMC ensured the accumulation and management of the DGF funds, and at the end of the year there were EUR 267.64 million in the DGF account in the Bank of Latvia, out of which EUR 74.24 million have been reserved for ensuring the guaranteed compensation (to the depositors of the deposit-takers in liquidation).

The FCMC ensured the accounts of the DGF in accordance with the financial accounting policy of the FCMC. The financial statements of the DGF for 2018 and the independent auditor's report thereon are available on the FCMC website at: https://www.fktk.lv/par-mums/gada-parskati/.

Disbursements of guaranteed compensation to the depositors of AS *Trasta Komercbanka*

The FCMC made the decision to charge AS *Trasta Komercbanka* to pay guaranteed compensation from the bank's own assets, considering that:

a) the provision of Section 25 of the Deposit Guarantee Law that the guaranteed compensation from the deposit-taker and from the assets of the DGF may be disbursed through the deposit-taker to whom the inaccessibility of deposits has occurred;

b) upon the occurrence of the inaccessibility of deposits, AS Trasta Komercbanka had sufficient funds to disburse the full guaranteed compensation to all its depositors which were entitled to the guaranteed compensation.

Therefore, no assets of the DGF had been used to disburse guaranteed compensation to the depositors of AS *Trasta Komercbanka*.

Table 5 Ensuring the disbursement of guaranteed compensation to the depositors of AS *Trasta Komercbanka*, as at 31 December 2018

AS *Trasta Komercbanka*			
	number of depositors	amount, EUR thousand	amount share, %
Rights to GC	5,108	60,509.8	100.0
Disbursed GCs	2,858	56,232.4	92.9
Unpaid GCs	2,250	4,277.4	7.1

FUND FOR THE PROTECTION OF THE INSURED

The assets of the FPI are made up of deductions of 0.1% by insurance companies from their total gross insurance premiums received from natural persons for the types of insurance specified in the law. Since the beginning of the operation of the FPI, the assets thereof have been allocated in an amount of EUR 12.3 thousand for the disbursement of guaranteed compensation.

As since the end of 2015, the amount of the assets of the FPI had exceeded the amount specified in Section 288 of the Insurance and Reinsurance Law the FCMC suspended contributions to the FPI in 2016. At the end of 2018, EUR 19.1 million was accumulated in the FPI.

The payment of insurance indemnity in the case of defaulting on the liabilities by the insurer may only be received by a policyholder who is a natural person:

1) for life insurance – 100% of the insurance indemnity, capped at EUR 14,230 per policyholder, excluding insurance in respect of the market-linked life insurance contract;

2) for other types of insurance set out in the law – 50% of the insurance indemnity, capped at EUR 2,850 per policyholder.

Where the FPI does not have sufficient assets for the disbursement of insurance indemnity under the *Insurance and Reinsurance Law*, the FCMC may enter into a loan agreement on lending the missing amount from one or several banks or insurers.

PROTECTION OF CUSTOMERS OF THE FINANCIAL INSTRUMENTS MARKET (INVESTORS)

The investor protection scheme is based on the Investor Protection Law. The compensation per investor is calculated for non-recoverable financial instruments or losses resulting from investment services that have not been executed. The compensation per investor is 90% of the value of the irrecoverable financial instruments or of the loss caused by a non-executed investment service, capped at EUR 20,000. The FCMC ensures the disbursement of compensation, whereas the Consultative Council of the Financial and Capital Markets monitors the payment of compensation.

The funds for the payment of compensation are provided by the participants of the scheme that are legal entities to whom the FCMC, under the set procedures, has issued a permit (licence) for the provision of investment services. During a year, the total of these funds must not exceed 4% of the total value of the financial instrument portfolio of the participants of the scheme. The payment of each participant of the scheme for ensuring compensation is established in proportion to the participant's share in the joint financial instrument portfolio of the participants of the scheme. Where the payments of the participants of the scheme are not sufficient to pay compensation under the Investor Protection Law, the FCMC is entitled to get a loan for the disbursement of compensation.

ADMINISTRATION OF THE FINANCIAL STABILITY FEE

The purpose of the FSF is to consolidate the entire financial system to finance, if necessary, the measures that would mitigate the negative impact of those credit institutions that have encountered financial difficulties on other participants of the financial market, as well as to partially compensate the State budget funds that have been channelled to stabilise the situation in the financial sector, from which the banking sector as a whole has benefitted directly or indirectly.

The FSF is paid by banks registered in the Republic of Latvia and their branches in the Member States and other foreign countries, as well as by branches in Latvia of banks registered in the Member States and other foreign countries. Under Section 6, Paragraph one of the Financial Stability Fee Law, the FSF is administered by the FCMC.

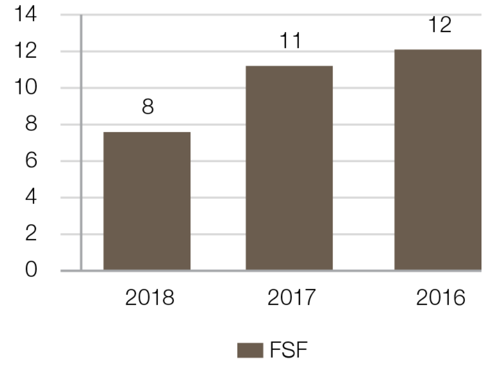
In 2018, the FCMC controlled the payment of the FSF into the state budget account, the calculation of the FSF, and the completeness and accuracy of the information underlying the calculation. The object of the FSF is comprised of the tax payers' liabilities, excluding deposits subject to the deposit guarantee scheme of Latvia or another Member State, issued mortgage bonds and subordinated liabilities, subject to the FSF rate in the amount of 0.072%. In 2018, the FSF was collected in the amount of EUR 10.05 million, which, as compared to 2017 (EUR 11.2 million), decreased by 10.3%.

Table 6
FSF payers' indicators

	2018	2017	2016
FSF payers	21	23	26
FSF object, in EUR million	10,540.4	15,563.1	16,802.9
FSF, in EUR	7,589,117	11,201,499	12,098,346
Fee payment received in the State budget, in EUR	10,046,568	11,249,954	14,973,548

The FSF amount payable according to the FSF payers' declarations for the corresponding fiscal year is reflected in Figure 27.

Figure 27
The FSF amount of Latvian banks and bank branches in Latvia for 2016-2018, EUR million



11 INTERNATIONAL COOPERATION

On an international scale, the activities of the FCMC are mainly focussed on cooperation and information exchange with supervisory authorities of other countries and participation in the SSM and the work of the European financial supervision authorities. The FCMC also provides support to the ministries in international forums regarding projects and issues relevant to the Latvian financial market, for example, by participating in the work of the EU Council or the OECD committees, and other forums.

International and European organisations

In the reporting year, the FCMC experts participated both on-site in the EU Council for consultation of the proposals related to the regulation of the financial sector and prepared written opinions and positions for Latvian representatives in meetings.

At the end of the year the negotiations were finalised on the **amendments in the framework of the capital requirements for credit institutions and recovery activities and resolution** and on the proposal for the **pan-European private pension product**. The negotiations continued on the **amendments** to the regulations governing the activities of the **European financial supervisory authorities,** on the proposals on **minimum loss coverage for non-performing exposures,** on **prudential supervision requirements for investment firms,** as well as on the **proposals related to the introduction of the development plan of the EU capital market.** An agreement was still not reached on the **creation of the European deposit insurance system.**

Outside the EU format, the FCMC is involved in the representation of Latvia in the OECD. In the OECD Working Group on Bribery, which also examines anti-money laundering issues, the fulfilment of recommendations of the Stage 2 report on Latvia was evaluated, and the FCMC reported on the accomplishments in the field of its competence. The work and information exchange in other OECD committees has entered an everyday mode. The FCMC regularly ensures the statistics in the fields such as pensions and insurance, which the OECD employs, when preparing the relevant sectoral summaries in all OECD countries. Likewise, the FCMC has provided its input in summarising the information on corporate governance issues of the companies quoted in the stock exchange.

In 2018, the representatives of the FCMC participated in the plenary session of the Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism of the Council of Europe Moneyval, where the compliance of the Latvian AML/CTF system with the international standards was evaluated. After publication of the report the FCMC accordingly implemented the measures to fulfil the recommendations included in the Moneyval Stage 5 evaluation for the Latvian AML/CTF system.

In 2018, the dialogue with the International Monetary Fund continued, on the basis of the consultation framework of Article IV of the International Monetary Fund Articles of Agreement. During the visits of the International Monetary Fund experts, information was provided regarding the market indices and topicalities in the sector, as well as on the adopted and planned changes to laws.

One of the key aspects of international cooperation is the participation of the FCMC in the work of the European supervisory authorities (the EBA, EIOPA, ESMA and ESRB), that gives opportunities to influence the formation of the European regulatory and supervisory policy and practice, and in the SSM established by the ECB. At the FCMC expert level, the work was carried out in the committees and working groups of the European supervisory authorities, whereas the FCMC management took part in the meetings of the Supervisory Board of these authorities.

In 2018, the EBA, supplementing the Single Rulebook of the European banking sector, approved several technical standards and guidelines in the field of securitisation and covered bonds, for the implementation of Payment Services Directive (PSD2), guidelines on non-performing exposures and continued the development of legal acts in other fields. The stress test of 2018 was performed that involved 48 largest banks from 15 countries, covering 70% of the banking sector assets. A unified approach was defined for further work in relation to the activities of the market participants of the United Kingdom after its withdrawal from the EU. In 2018, the EBA evaluated the practices and cooperation of the Member States, issuing permits for pursuing the activities of credit institutions and forwarding the notification on cross-border activities.

Additional information on the activities of the EBA in 2018 may be found on the website https://eba.europa.eu/news-press/news/2018.

IN 2018, the EIOPA approved technical standards for the implementation of the Insurance Distribution Directive in relation to the professional activity insurance issues. Also, the EIOPA sent the opinion of the EC on the development of the legal acts delegated in the Insolvency II Directive and the necessary changes in this Directive. The EIOPA continuously monitored and assessed the risks to the insurance and pension sector and the vulnerability of the industry with a view to facilitating or coordinating supervisory activities, if necessary. The stress test of the EU insurance sector was carried out and its results were made public at the end of 2018. The InsurTech issues were updated. Similarly as in other institutions, the issues related to the withdrawal of the United Kingdom from the EU were on the agenda.

In March 2018, the FCMC welcomed in its premises the EIOPA Peer Review working group on pension issues in a visiting meeting, as this group was chaired by the FCMC representative.

Additional information on the activities of the EIOPA in 2018 may be found on the website https://eiopa.europa.eu/press-room/press-releases.

In 2018, the ESMA approved technical standards for the implementation of the prospectus regulation, the securitisation regulation, the over-the-counter derivatives, the central counterparty and the transaction registers regulation (EMIR). In addition to the technical standards, the guidelines for the application of the central securities depositories' regulation were adopted. The guidelines on the aspects of the MiFID II eligibility requirements were also approved.

The ESMA continued negotiations with the countries of the International Organisation of Securities Commissions to make changes to the information exchange agreement that would comply with the new European data protection framework, and at the beginning of 2019 an agreement was reached on the version of changes. Also, much attention was paid to the fields and solutions that are important in relation to the United Kingdom's, as a significant player of the financial market, withdrawal from the EU.

Additional information on the activities of the ESMA may be found on the website https://www.esma.europa.eu/press-news/esma-news.

The ESRB assessed the stability risks of the EU financial system. In 2018, they were still high, taking into consideration significant political uncertainty in the world and the EU. The ESRB assessed both cyclical and structural risks in the EU financial system, focussing on the adequacy of macro-prudential policy measures in Member States. The role of macro-prudential policy in preventing systemic growth of the NLP and strengthening banks' resilience to such growth was explored separately. In relation to structural risks, the ESRB published an analysis on the use of the structural buffers, i.e. the buffer for global systemically important institutions, the buffer for other systemically important institutions

(O-SSI) and a systemic risk buffer.

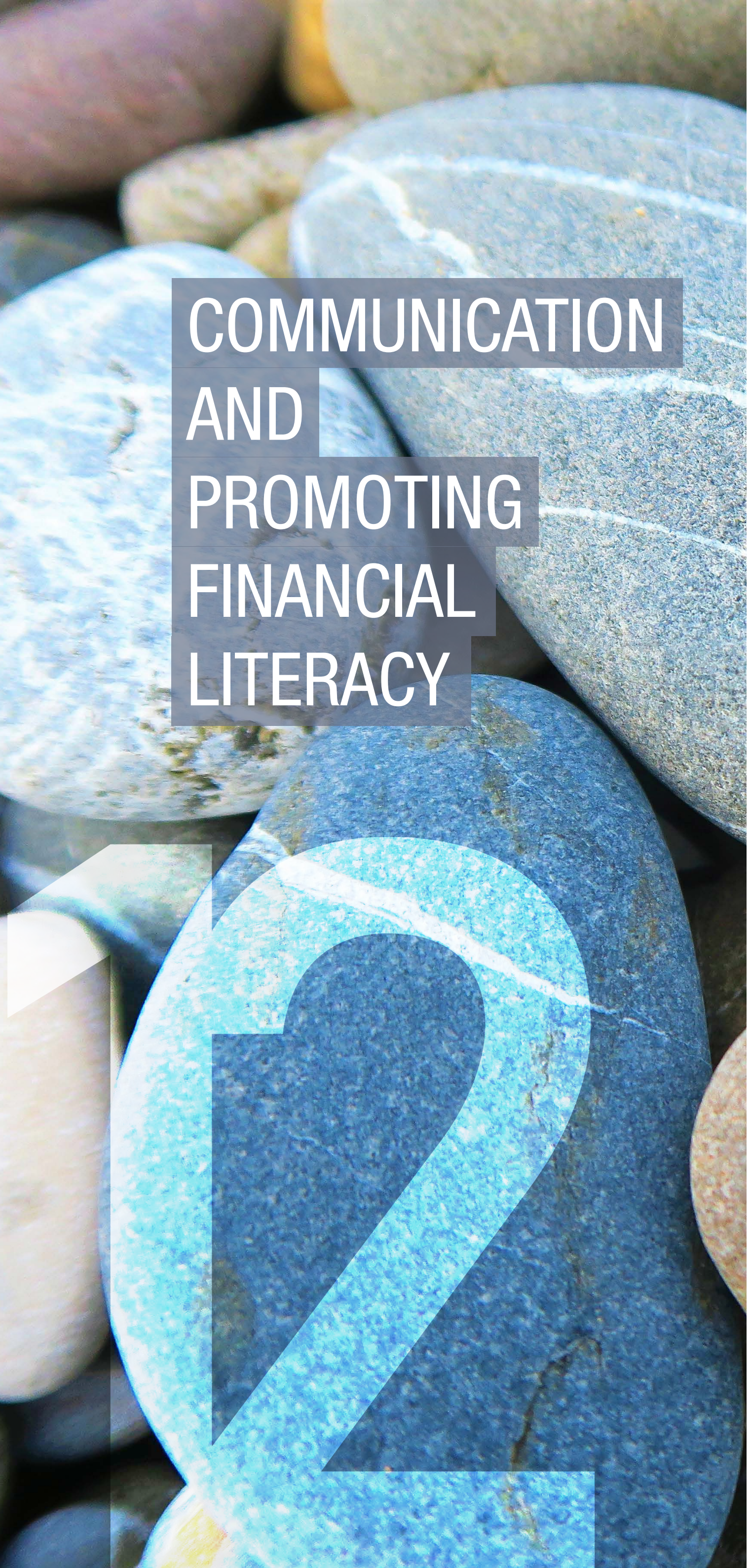
Additional information on the activities of the ESRB may be found on the website www.esrb.europa.eu.

The FCMC activities within the SSM established by the ECB are reflected in the section on banking supervision.

Bilateral cooperation

In ensuring the supervision and stability of the financial sector, cooperating with the supervisory authorities of the financial sector of other countries plays an important role. In 2018, new agreements were signed in the field of deposit guarantees only. In order to ensure effective activities of deposit guarantee funds, agreements were concluded with Swedish, Lithuanian and Estonian managers of deposit guarantee systems on the procedures of mutual exchange of information and procedures on the disbursement of guaranteed compensation.

The FCMC exchanged information within the existing concluded agreements. The FCMC received the most information requests according to the agreement with the International Organisation of Securities Commissions. There is a positive result of on-site cooperation as well. Supervisor and resolution colleges have played a significant role in experience and information exchange, more details whereof are mentioned in the section on supervision of the report.



12 COMMUNICATION AND PROMOTING FINANCIAL LITERACY

According to the strategic guidelines of the institution, in 2018 the FCMC also ensured the wide availability of information to the public through the media on topical issues, operative information flows on the website, as well as, promoting financial literacy, carried out numerous activities in this field.

EXTERNAL COMMUNICATION

In 2018, the FCMC was mentioned in the media 9,603 times, which is significantly more than in the previous year (3,043 times), including 4,659 times in the first quarter of the year, which can be explained by the exceptional circumstances in the reporting period both in the key activities of the FCMC and the external communication flow in relation to the "Proposal of Special Measure Against ABLV Bank, AS as a Financial Institution of Primary Money Laundering Concern" published by the FinCEN on 13 February 2018. In this period (February – March) the most extensive direct cooperation in the foreign media segment was also carried out, both by organising the FCMC Chairman's press conference in English and by providing regular daily information to the leading media in the financial sector, as well as to other media – Reuters, Bloomberg News, The Wall Street Journal, Financial Times, The New York Times, Radio Sweden, Radio France, Voice of America, etc.

The Communications Division, in parallel to the daily information flow, in this phase organised three thematic on-site events or press conferences for the Latvian media environment – on 16 February 2018 on the current situation in ABLV Bank and in the banking sector after the FinCEN notification, on 24 February 2018 on the decision of the ECB and the FCMC to impose restrictions on ABLV Bank and to declare unavailability of deposits in the bank, and on 2 March 2018 on the procedure of guaranteed compensation disbursement to the clients of ABLV Bank, as well as one more media event was organised on 12 June 2018 when the decision was taken to allow ABLV Bank to implement the submitted self-liquidation plan.

In the reporting year, the Communications Division issued 155 communications to the mass media in Latvian and 33 in English (in 2017, 114 and 21, respectively) on the decisions taken by the Board of the FCMC, the activities of financial market participants, topicalities of regulatory requirements, changes implemented in the banking sector and the evaluation of the new business models of 12 banks, as well as the sanctions imposed by the FCMC on market participants. 10 infographics were developed and made public on payment initiation services and account information services in relation to the implementation of PSD2, results of the banking sector in 2017, financial literacy results in 2017 and six – on the change of the business approach in the banking sector and the change management carried out by the FCMC. The FCMC continued ongoing communication on social networks as well, by maintaining the dialogue with the public on the microblogging site Twitter, as well as by posting materials on the websites YouTube and SlideShare.

The intense daily communication flow, as well as regular interviews of the FCMC management, organised by the Communications Division within the scope of its expertise, both for the Latvian and the international media environment, ensured a wide-ranging explanatory work that gradually contributed to the change of understanding in the media environment regarding both the work of the FCMC in managing the changes in the financial sector and the process of transformation of the Latvian financial sector as a whole.

DEVELOPMENT OF DIGITAL TOOLS

In 2018, the Communications Division in cooperation with the Information Technology Division started the scheduled reconstruction of the FCMC website www.fktk.lv, in order to establish a modern and easy-to-use database for market participants, as well as a new platform for informing the public, following the current needs of the digital economy. In parallel to this work, the audit of content and usability was conducted on the existing website in the reporting year, design sketches were developed and approved, and the new design was passed for programming. In the first half of 2019 the programming is ongoing and the data migration has been started for the publication of the new website.

Ensuring support for Latvian FinTech start-ups in the financial sector, the virtual consultations environment Innovations Centre continued its work on the FCMC website, where it is possible to obtain all of the necessary information in one place, as well as to directly address the FCMC experts. In the reporting year, in total 30 individuals applied to the FCMC experts and received the necessary consultations on the new financial services (account information services and payment initiation services, as well as on expressing initial coin offerings (ICO) and the regulations applicable thereto in Latvia) included in the payment services Directive (PSD2), see https://www.fktk.lv/en/licensing/innovation-centre/team/ .

In order to raise awareness among clients of market participants and also of the general public about the current quarterly performance indicators of banks operating in Latvia, the design of the interactive tool Banking Compass was reconstructed, see https://kompass.fktk.lv/bankas/en/assets .

In turn, to ensure public awareness about the key characteristic indicators of the financial stability of insurance companies and their branches operating in Latvia, the Insurance Compass was developed and published in 2018, see https://kompass.fktk.lv/apdrosinasana/en/solvency-ratio .

Likewise, in the context of the world events a Brexit section was set up on the FCMC website which contains useful information summarised in relation to the impact of the withdrawal of the United Kingdom from the EU on the financial and capital markets, see http://www.fktk.lv/lv/brexit-apvienotas-karalistes-izstasanas-no-es.html .

CORPORATE COMMUNICATION

During the reporting year, the FCMC continued the corporate communication activity FCMC Dialogue, maintained the negotiation platform with market participants regarding important development issues. The purpose of this initiative is to involve the participants of the sector more actively in the planning of the development of the sector, ensuring the support of the FCMC for weighted sustainability-enhancing ideas. The FCMC Dialogue in cooperation with Vilands Associates took place on 26 April 2018, preparing for the introduction of PSD2, and the FCMC experts discussed the development and cooperation possibilities between banks and FinTech companies with the representatives of the financial sector.

In 2018, the role of corporate relations increased within the external communication implemented by the Communications Division to strengthen both the reputation of the FCMC as a professional supervisory authority and the international reputation of the Latvian financial sector. The Communications Division of the FCMC was also involved in the activities of the Financial Sector Development Council and strategic communication activities of the Government, as well as developed the content for the news page of the Cabinet of Ministers Financial Sector Update on a regular basis. The participation of the FCMC was ensured in the public hearing "Combat of Money Laundering in the EU Banking System" of the Special Committee TAX3 of the European Parliament that took place on 26 April 2018, as well as an additional report was presented by the FCMC Chairman during the visit of TAX3 representatives in Riga on 31 August 2018. This cooperation was appreciated by an official recognition of the head of the TAX3 Committee to the FCMC.

IMPROVEMENT OF CRISIS MANAGEMENT

Effective cooperation with the sector is important, especially in extraordinary situations and during the crisis. Therefore, in 2018 the Communications Division of the FCMC developed a new version of the "Plan for crisis communication of the financial sector", including therein the cybersecurity aspect, as well as more cooperation partners. The plan was approved on 13 February 2018 in the meeting of the Financial Sector Development Council. There was a possibility to verify the compliance of the plan with the new conditions in the financial sector in real crisis situations in 2018. In addition, individual action plans were developed as well for the cooperation with partner institutions. The experience of the crisis situations (February – May 2018) is summarised, both the crisis management mechanism among the FCMC structural units is being improved and the development of the guidelines for market participants will be continued in 2019, in order to create a unified understanding and approach to the exchange of information with the FCMC during crisis communication situations.

PROMOTING FINANCIAL LITERACY

One of the priority directions of the work of the FCMC is to promote the financial literacy of the population, by ensuring the coordination of activities at the national level, representation in the OECD working group International Network on Financial Education and research activity.

Strategy

In assessing the fulfilment of the planning document Strategy for Financial Literacy of the Population of Latvia for 2014–2020 (hereinafter in this section – the Strategy), it can be seen that overall the indicators of the achievement of the strategic goals of the financial literacy demonstrate the desired progress. The most significant positive trends are the growing digitisation of financial services and the involvement of inhabitants in the use of such tools, the steady growth of domestic deposits for several years, the focus on long-term investments, and the increasingly healthy loan to deposit ratio – 70/100. Summarising the data on household financial sustainability in 2018, the FCMC sustainability index shows the result of +12.8 points (in 2017 +9.5 points). The rapid economic growth has led to more favourable financial conditions for households in 2018 as well, but, despite a relatively constant rise in household deposits, to ensure their sustainability in the event of future shocks the amount of savings on average should be higher.

Financial literacy week 2018

According to the partner agreement on organisation of the annual financial literacy week, so that financial literacy materials would reach increasingly new population groups, also in 2018, simultaneously with the seventh Global Money Week organised by the Child and Youth Finance International, the FCMC organised the sixth financial literacy week in Latvia. The concept of the week of 2018 was “Where does the money live?”, emphasising that the environment of financial services is becoming increasingly digital. The possibilities to carry out transactions and follow one’s financial situation have broadened. Therefore, within the week a single website or a digital office for the coordination of activities of the financial literacy partners was opened, where all the materials on financial literacy can be found – the Strategy, Standard of competences, latest Latvian and international research, archive of the financial literacy weeks, studies, news feed, time line of financial literacy development events in Latvia and links to current study materials, see www.finansupratiba.lv.

Along with these activities partner lectures and practical classes took place all year long in secondary schools and higher education institutions and the Communications Division ensured regular lectures to pupils in the National Library of Latvia. Also, the improvement of the content of the educational vortal Client School was continued.

KEY TASKS IN 2019

Supervising credit institutions:

- The assessment of the strategies and business models of banks – ongoing processes started already in the previous years, by continuous follow-up of the bank's capacity to adapt to new conditions, the development of new activity directions and reaching the goals set, with a special focus on profitability and sustainability of the new business models.

- Strengthening the operational compliance and risk control functions – assessment of effective functioning of the internal control system of banks, risk appetite defined by banks, the risks they have undertaken and their ability to manage them, especially assessing these areas in the context of business model change.

- Continuing the assessment of operational recovery plans of banks, taking into consideration the important role of recovery plans in ensuring stable operations of banks.

- Continuing the work on the improvement of the quality control mechanism of the reports submitted by banks, as, taking into account the complicated structure of the reports, their quality assurance plays a significant role.

- Continuing the assessment of credit risk management, including exposure concentration and adequacy of provisions, paying particular attention to problematic loans.

Supervising the financial instruments market:

- strengthening the investors' interest protection, by supervising the compliance of the services of the investment service providers with the requirements of legal acts, as well as supervising trades in financial instruments and assessing the necessity for product intervention;

- convergence of the supervisory practice of the financial instruments market participants, taking into account the ESMA framework;

- promotion of the disclosure of issuers' information, including the improvement of the quality of financial reports and appropriate disclosure of financial notifications and alternative performance indicators;

- implementing the supervisory process of the central securities depository in accordance with the EU Regulation on central securities depositories.

Supervising the insurance market participants:

- carrying out of on-site and off-site inspections of insurance market participants according to the approved plan of supervision measures;

- improving the on-site and off-site supervision process of insurance market participants, by supplementing on-site and off-site supervision guidelines according to the changes in the binding legal acts;

- enhancing the supervisory framework of the insurance and reinsurance distributors, in order to ensure the supervision of the compliance of the activities of the insurance and reinsurance distributors with the requirements of the Insurance Distribution Directive ensuring the protection of interests of their customers (consumers) corresponding to the requirements of the Directive.

Supervising pensions and investments:

The supervision priority of the market segments under the authority of the Pensions and Investment Funds Division – supervision of private pension funds. The priorities have been set taking into consideration the regulatory framework (the duty to carry out on-site inspections of private pension funds every three years and changes to the regulatory framework related to the introduction of the Directive on the activities and supervision of institutions for occupational retirement provision (IORP II Directive)).

Supervising compliance:

The main task in AML/CTF field – to ensure the fulfilment of the tasks set by the "Action Plan for Prevention of Money Laundering and Terrorist Financing for the Time Period until 31 December 2019" approved by the Cabinet of Ministers, in order to decrease AML/CTF risks, ensuring compliance with the international obligations and standards in the AML/CTF field.

In the field of regulatory requirements:

- Introduction of the amendments to Regulation No. 575/2013 (CRR II) and Directive No. 2013/36/EU published in the Official Journal of the European Union on 7 July 2019. The amendments provide for significant changes in the regulation of credit institution activities;

- Development and introduction of the new version of the Normative Regulations on Credit Risk Management, where changes in several aspects of credit risk management were introduced, for example, a requirement to carry out regular monitoring of the value of loan collateral and its liquidity, more detailed requirements for forbearance policy and for the application of forbearance measures, including the features that are indicative of financial difficulties of a client, the requirement to assess various aspects (the borrower's financial situation, the cause, severity and expected duration of the financial difficulties, alternatives for the application of forbearance measures) before the application of the forbearance measures, additional requirements for institutions with an increased share of NPL (NPL ratio above 5% or individual credit portfolios are with high NPL concentration);

- in cooperation with the Bank of Latvia, the Consumer Rights Protection Centre and Finance Latvia Association work on changes in the requirements for loan issuance that introduces binding quantitative restrictions on the loan ratio to the value of collateral and the ratio of the amount of loan and its servicing payments to the borrower's income for loans issued to individuals.

In the field of the crisis management resolution mechanism:

- ensuring effective integration into the single resolution mechanism and single investment insurance mechanism, by enhancing the internal regulatory framework of the resolution and cooperation with the foreign investment guarantee fund managers;

- enhancing the crisis management process, by means of an effective and coordinated crises management mechanism, including communication mechanism;

In the FCMC governance:

- enhancing the internal communication and information flow processes;

- strengthening the FCMC capacity, including the field of AML/CTF and international sanction supervision;

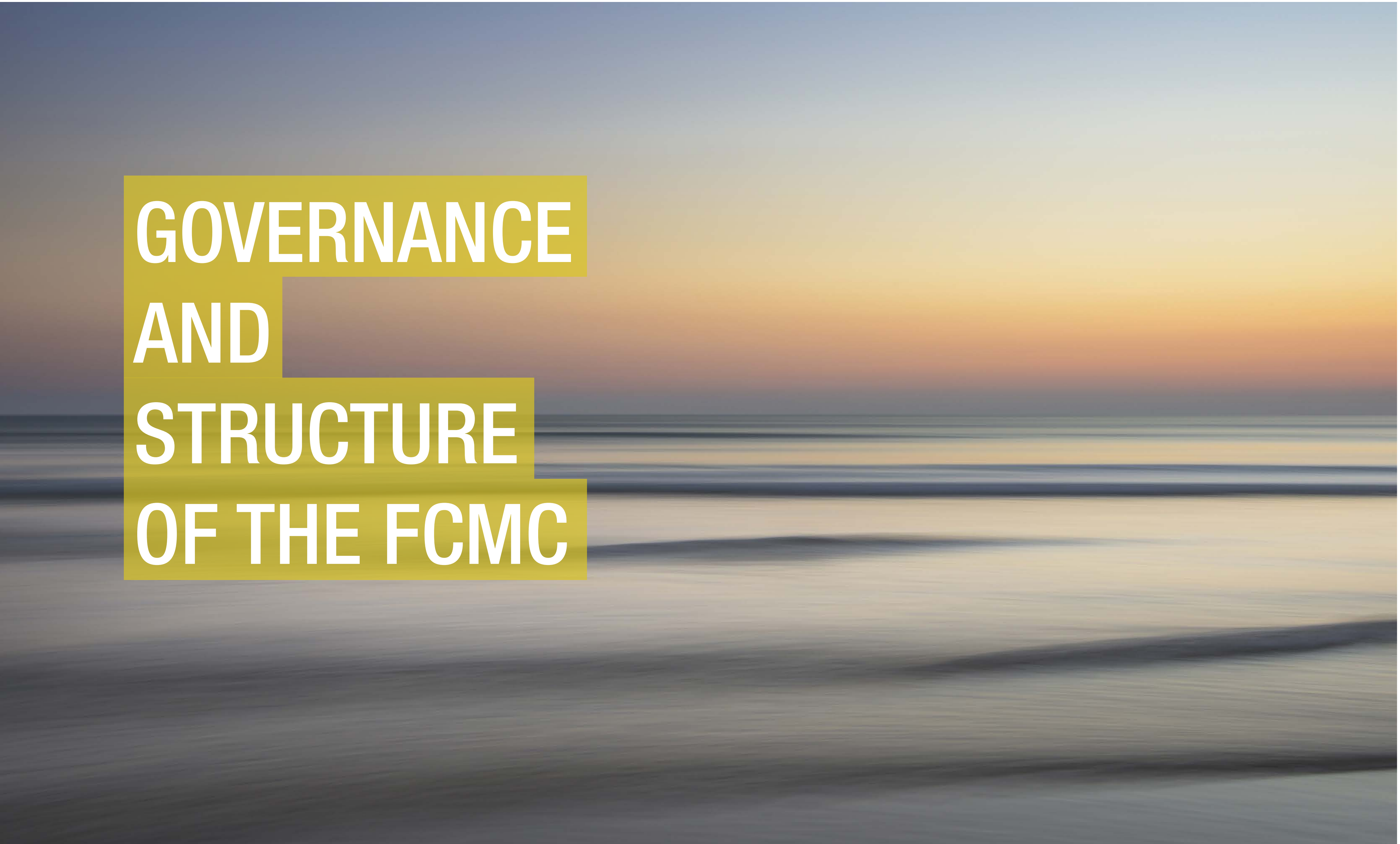
- optimising internal processes, by reduction of the ineffective operations;

- continuing to improve the FCMC quality management system according to the principles of the quality management model (European Foundation for Quality Management);

- continuing to develop staff competences, professional knowledge and skills through targeted and thoughtful management of personnel, development of managerial competencies and management of accumulated knowledge;

- continuing to develop a modern and secure IT-based work environment, enhancing the efficiency of information processing required for information flow management and decision-making, as well as strengthening IT security.

GOVERNANCE AND STRUCTURE OF THE FCMC



STAFF POLICY

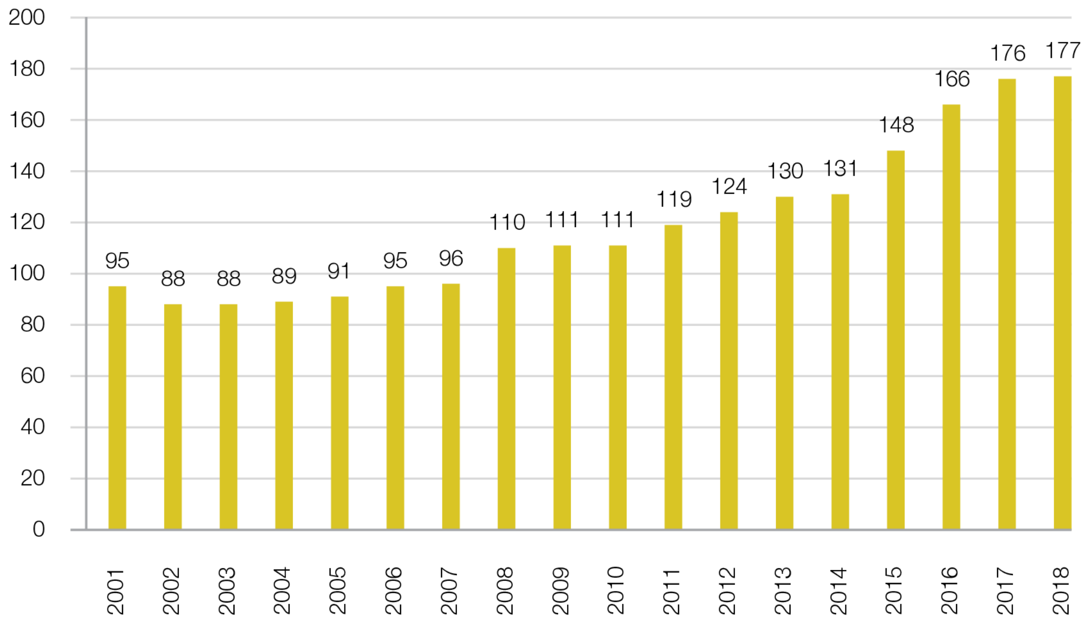
Highly educated and professional staff plays a major role in the achievement of the strategic goals of the FCMC and the further development of the institution.

STAFF BREAKDOWN BY NUMBER AND THE CHANGES THEREOF

In the reporting year, the number of the FCMC job positions increased by one job position in comparison with the previous year and reached 177 job positions.

In order to ensure integrated risk identification and supervision in the field of AML/CTF of the bank and non-bank sectors, as well as to enhance communication with other structural units, the job position of the Deputy Director of the Compliance Control Department was opened.

Figure 28
Staff number dynamics, 2001-2018



In 2018, the average number of employees, including those on long-term leave, was 168.7. At 31 December 2018 the FCMC employed 168 employees, whereof:

- 138 (82%) were engaged in performing principal activities and 30 (18%) were engaged in performing support functions;

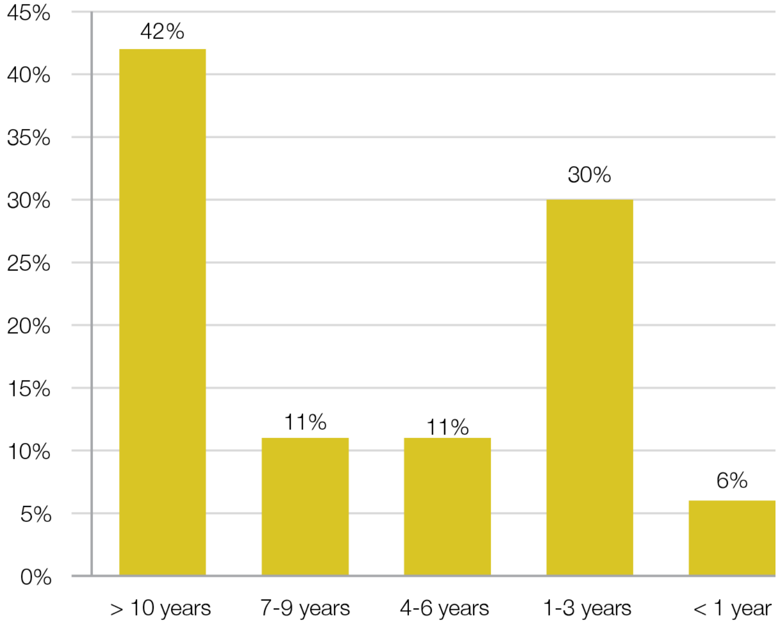
- 119 (71%) were civil servants and 49 (29%) were employees;

- all employees were engaged in performing intellectual work.

In 2018, the staff turnover rate was 7.9%. During the reporting year, 12 employees were hired by the FCMC, including eight employees who were hired for performing principal activities and four employees who were hired for performing support functions, whereof one employee was hired by the FCMC for a definite term, i.e. for the term required to replace an employee on extended leave of absence (childcare leave). After the expiry of the probation period, in accordance with the established adaptation period plan, all of the new employees received a positive assessment and continued to be employed by the FCMC. During the reporting year, the FCMC terminated the employment relationship with 14 employees. Of the seven permanent employees who terminated their employment relationship with the FCMC, one employee retired, while the others chose to pursue a career in both the public and the private sector (including one who is working in Germany).

At the end of 2018, 96% (158) of employees of the FCMC had been employed by the FCMC for more than one year, 26% (44) employees – for 17 years, i.e. as of its establishment (year 2001), and 6% (10) employees had been employed by the FCMC for less than a year.

Figure 29
Breakdown of staff by length of service at the FCMC



JOB-RELATED BUSINESS TRIPS

During the reporting year, 106 (61.27%) employees were assigned on 516 business trips, of which:

- 89 (51.4%) employees were involved, on a regular basis, in the work of the task forces established by the European Union and the European financial supervisory authorities (EBA, EIOPA, and ESMA);

- 13 (7.5%) employees were regularly involved in the events of the task forces of the European Council;

- The Chairman of the FCMC, as the representative of the LR, participated in the Spring session of the International Monetary Fund and the World Bank;

- two employees met with US financial supervision authority representatives as experts in Washington and New York.

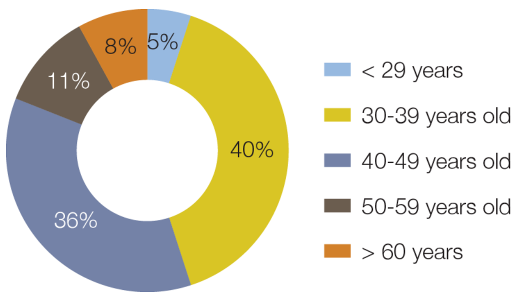
BREAKDOWN OF FCMC STAFF BY GENDER AND AGE

In 2018, 73% of all FCMC employees were women (123), whereas 27% were men (45). In the reporting year, the age profile of the staff was characterised by the following indicators: 5% of employees (9) were aged up to 29 years old, 40% (67) were aged from 30 to 39 years old, 36% (60) were aged from 40 to 49 years old, and 19% (32) were aged over 50 years old.

In 2018, the average age of the FCMC staff was 43.1 years old.

Figure 30

Breakdown of the FCMC staff by age groups, %

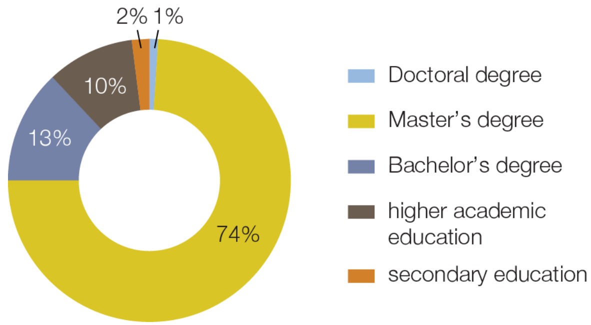


STAFF QUALIFICATIONS

In the reporting year, 98% of the FCMC employees (165) had a university degree (of which 74% had a Master's Degree), but 2% of employees (3) had general secondary or professional secondary education.

Figure 31

Breakdown of FCMC staff by educational attainment level, %



IMPROVING STAFF QUALIFICATIONS

With a view to improving FCMC activity processes whilst thereby raising the effectiveness and efficiency of the performance, as well as for carrying out the supervision of the financial sector, especially of the banking sector, 71% of FCMC staff (119) improved their qualifications by attending job-related training held in Latvia, including training on extensive data analysis and administration (SAP Business Objects Web Intelligence, IBM Domino) and latest developments of IT system security, on General Data Protection Regulation, risk and process management, FinTech issues, prevention of corruption and conflict of interest risks, as well as determination of capital share/stock value of companies according to the international valuation standards and the international private equity and venture capital valuation guidelines. Within the scope of the Structural Reforms Support Programme of the EC, employees of the FCMC Compliance Control Department continued to attend the training in the field of raising the effectiveness of anti-money laundering.

50% of the FCMC employees (84) attended seminars abroad on a variety of issues on financial supervision and regulation, including improved knowledge on the increase of effectiveness of money laundering, on-site and off-site supervision of banks (FINREP, COREP, SREP IT, SREP of less important institutions), management of bank risks, as well as on IFRS 9 regulation in the field of bank supervision regulatory requirements, ICAAP, ILAAP, Basel III, regulatory requirements in relation to NPL and other topics.

STAFF PERFORMANCE APPRAISAL

In 2018, under the procedure set forth by the FCMC, 160 employees underwent staff performance appraisals, including 30 heads of structural units (including three members of the board) and 130 subject-matter experts.

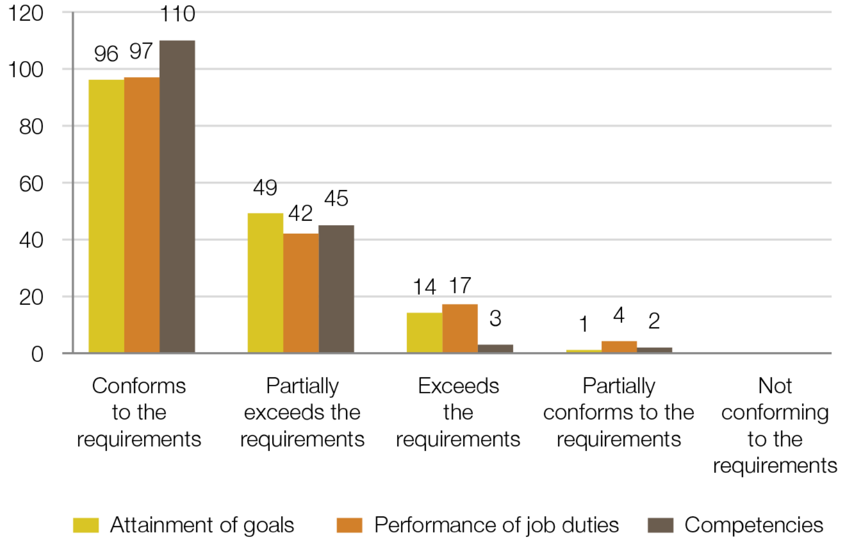
Three criteria were set for assessing performance: attainment of established goals, performing of job duties, and the required job-related competencies.

59% of employees (94) received the overall assessment of all criteria as Conforms to the Requirements, 38% of employees (61) received the assessment Partially Exceeds the Requirements, 1% of employees (2) received the assessment Exceeds the requirements, while 2% of employees (3) received the assessment Partially Conforms to the Requirements. In 2018, none of the employees received the overall assessment of all criteria as Not Conforming to the Requirements.

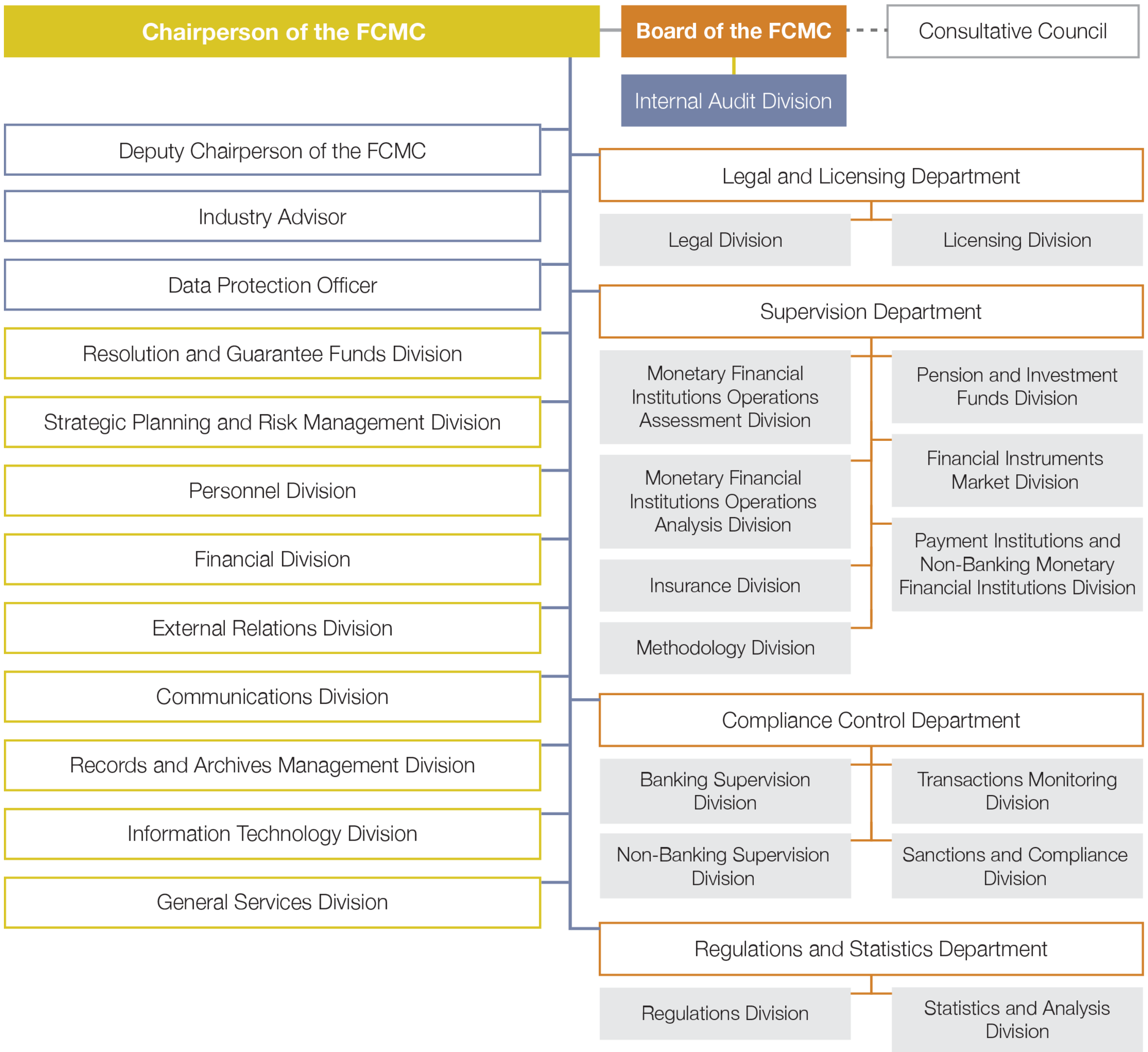
The majority of employees also received the assessment Conforms to the Requirements including regarding each individual criterion – for attaining established goals – 60% of employees (96), for the performance of job duties – 61% of employees (97), and for the required job-related competencies – 69% of employees (110).

Figure 32

Breakdown of the SPA assessment by criteria, number of employees



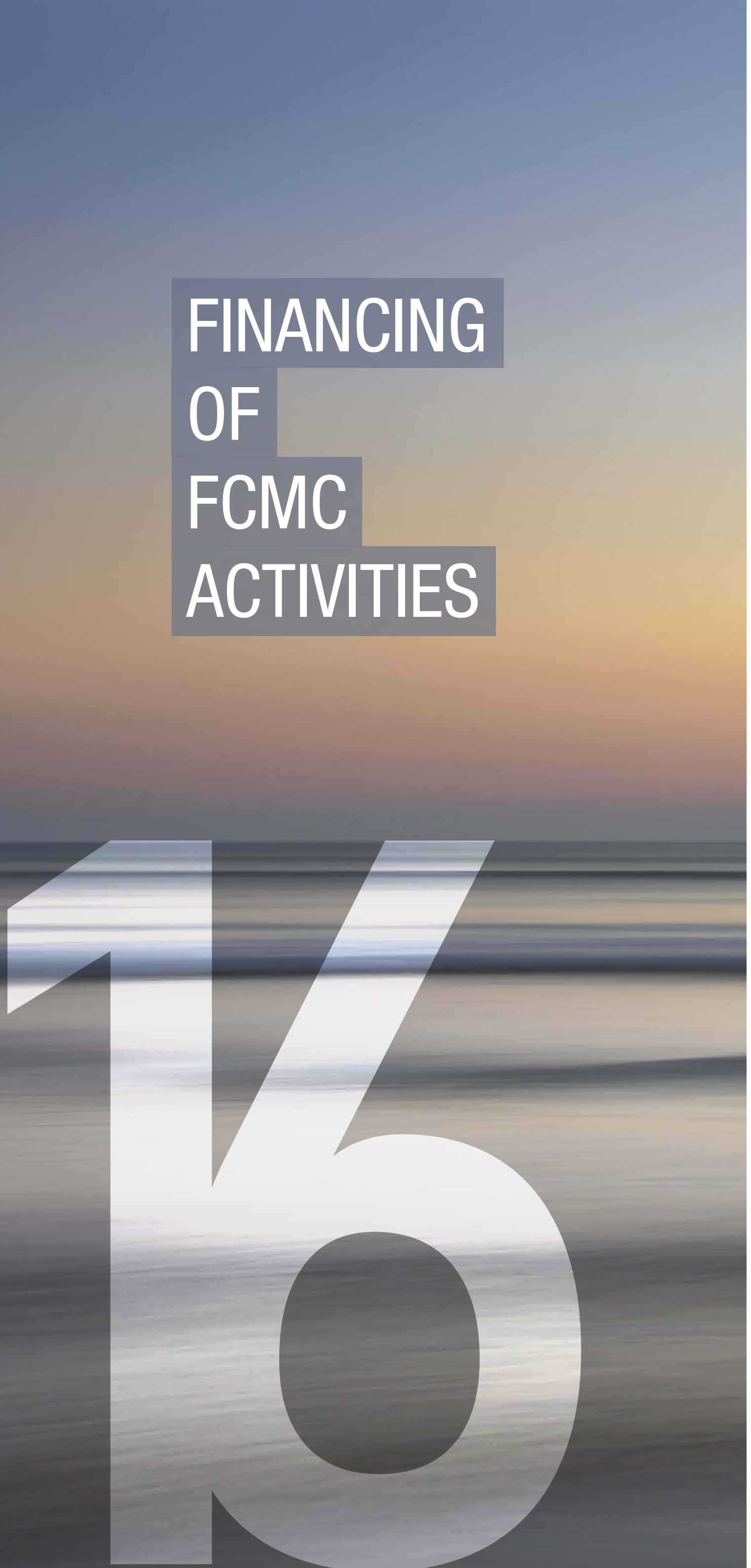
14 FCMC STRUCTURE



QUALITY AND RISK MANAGEMENT

Quality and risk management in the FCMC is ensured by the Strategic Planning and Risk Management Division, the aim of operation whereof is in line with its competence, to promote constant enhancement and improvement of the activities of the FCMC. In 2018, the FCMC continued to enhance the quality management system. During the reporting year, the governance assessment was finalised in accordance with the criteria of Common Assessment Framework model, and its results were used for the determination of the measures for process improvement to be carried out in the following year, as well as for the definition of the FCMC strategy for the following period.

Risk management is an important component of the FCMC management processes, within the scope whereof the risks are identified, analysed and assessed, by planning and implementing the risk mitigating measures, monitoring and reviewing the risks, and thereby promoting the achievement of the goals of the FCMC and the effective process of project management. In 2018, the FCMC continued the enhancement of the risk management process established during the previous years in accordance with the international best practices, as well as in line with the requirements set by the ECB in the field of risk management. Enhancement of the risk management process will continue in 2019.



16 FINANCING OF FCMC ACTIVITIES

In 2018, the activity of the FCMC was fully financed from the payments of participants of the financial and capital markets. During the reporting year, within the scope of the budget for ensuring FCMC activity, the FCMC also managed the DGF and the FPI, as well as administered the FSF contributions to the state budget and contributions to the SRF at European level. The FCMC carried out the administration of the DGF and FPI, as well as the FSF and SRF within the scope of the approved budget, and the financial means from these funds were not deducted for the administration needs thereof for the benefit of the FCMC.

Table 7
Financing of the activities of the FCMC in 2017-2018, in EUR

	Actual[26] performance in 2017	Actual[26] performance in 2018	Budget[26] for 2018	Budget performance for 2018, %	Share of the actual performance in total in 2018, %
REVENUE (+)	10,515,550	11,034,856	12,170 519	91	100
PAYMENTS BY THE PARTICIPANTS OF THE FINANCIAL AND CAPITAL MARKETS	10,484,140	10,995,604	12,154 519	90	99.6
REVENUE RELATED TO THE SUPERVISION OF MONETARY FINANCIAL INSTITUTIONS	7,793,057	8,143,648	9,448,019	86	73.8
Payments by credit institutions	7,491,052	7,853,562	9,149,907		
Payments by credit unions	36,988	39,929	36,960		
Payments by payment institutions	96,038	80,507	98,056		
Payments by electronic money institutions	170,431	174,872	163,096		
Lost income	-1,452	-5,222			
REVENUE RELATED TO THE SUPERVISION OF THE FINANCIAL INSTRUMENTS MARKET AND PRIVATE PENSION FUNDS	991,718	963,222	945,640	102	8.7
Payments by participants of the financial instruments market	689,205	663,153	696,040		
Payments by private pension funds	302,513	300,069	249,600		

[26] In accordance with the accruals principle, except accruals for leave, which are not included in the planning of the budget and the control of the budget performance.

	Actual[26] performance in 2017	Actual[26] performance in 2018	Budget[26] for 2018	Budget performance for 2018, %	Share of the actual performance in total in 2018, %
REVENUE RELATED TO THE SUPERVISION OF INSURANCE	**1,699,365**	**1,888,733**	**1,760,860**	**107**	**17.1**
Payments by life insurance companies	341,584	343,051	320,940		
Payments by other insurance companies	1,301,076	1,489,768	1,364,920		
Payments by insurance brokers	56,755	55,914	75,000		
Lost income	-50				
OTHER REVENUE	**31,410**	**39,252**	**16,000**	**245**	0.4
EXPENSES (-)	**9,915,835**	**10,664,559**	**11,997,130**	**89**	**100**
Salary for work, other payments to employees, and national social insurance mandatory contributions	7,220,561	7,843,178	8,860,332	89	73.5
Employee insurance	56,815	44,390	61,258	72	0.4
Improving professional qualifications of the staff	179,585	140,253	188,196	75	1.3
Telecommunications, communications, and information	153,473	152,880	166,363	92	1.4
Information to the general public, internal and external communication	76,650	53,127	142,860	37	0.5
Maintenance and operational expenses	823,114	849,593	848,979	100	8.0
Services for the provision of supervision	114,323	268,161	149,414	179	2.5
International cooperation	1,095,813	1,104,230	1,345,023	82	10.4
Amortisation/depreciation of capital investments	195,501	208,747	234,705	89	2.0
RESULT	**599,715**	**370,297**	**173,389**		

[26] In accordance with the accruals principle, except accruals for leave, which are not included in the planning of the budget and the control of the budget performance.

In 2018, the income of the FCMC did not reach the planned income in the amount of EUR 1.136 million, as the activities of one of the biggest banks were suspended in 2018 and re-focussing of the banking business model took place that changed the structure of bank assets and their volume, which directly affects the financing of FCMC activities. The actual financing of the FCMC increased by 5% in 2018 compared to 2017, though the planned increase was 14% of the payments of market participants. In 2018, 60% of the FCMC working resources were allocated to the function of financial market supervision, whereas for client interest protection and AML/CTF control – 15%, but for the management and support function – 25%. During 2018, the functions in the field of compliance control and resolution and guarantee system enhancement were implemented, to which increased resources were granted already in 2016 and an equivalent was maintained both in 2017 and 2018 in the amount of 14%–15%.

In the field of AML/CTF control, significant funds were also spent to pay for the outsourced services.

In 2018, FCMC financing was fully planned from the contributions of market participants. It was planned that 77.7% of all payments by market participants would be sourced from monetary financial institutions, 7.8% from financial instruments market participants together with private pension funds, but 14.5% of payments would be sourced from insurance market participants. However, in accordance with the actual fulfilment of the plan the monetary financial institutions ensured financing in the amount of 86% of the planned one, thus ensuring contributions into the FCMC budget in the amount of 73.8% of the total financing by market participants in 2018.

Table 8
Breakdown of FCMC staff remuneration in 2018, in EUR

Salaries and similar payments	**6,332,788**
including bonuses	243,038
including additional payments	39,949
including remuneration to the FCMC Board	427,576
National social insurance mandatory contributions	**1,510,390**
including the national social insurance mandatory contributions on the remuneration of the FCMC Board	102,942

In 2018, the actual total budget expenses (without provisions for annual leave and without the reinstatement costs of the previous periods) comprised EUR 10,664.6 thousand, which is 11% less than planned (EUR 11,997.1 thousand). The planned non-acquisition of the budget expenses is connected with the balancing of the actual FCMC's expenses with the actual revenue in 2018.

In 2018, the major costs of operational provision of the FCMC were comprised of the expenses on remuneration of employees of the FCMC (73.5%).

In 2018, the leasehold expenses of the FCMC were EUR 454.8 thousand, which constituted 4.2% of the total FCMC expenses. The leasehold expenses also included archive shelf lease and the expenses of lease of the branch advisor's office in the USA until 31 May 2018. The office premises of the FCMC are at 1 Kungu Street, in Riga, and at 2 Krāmu Street, in Riga, with a total area of 2,306.1 m^2.

In 2018, the FCMC represented Latvia in eight European and global financial market supervision and its coordination organisations, the membership of which cost 4.9% more than in 2017.

Table 9

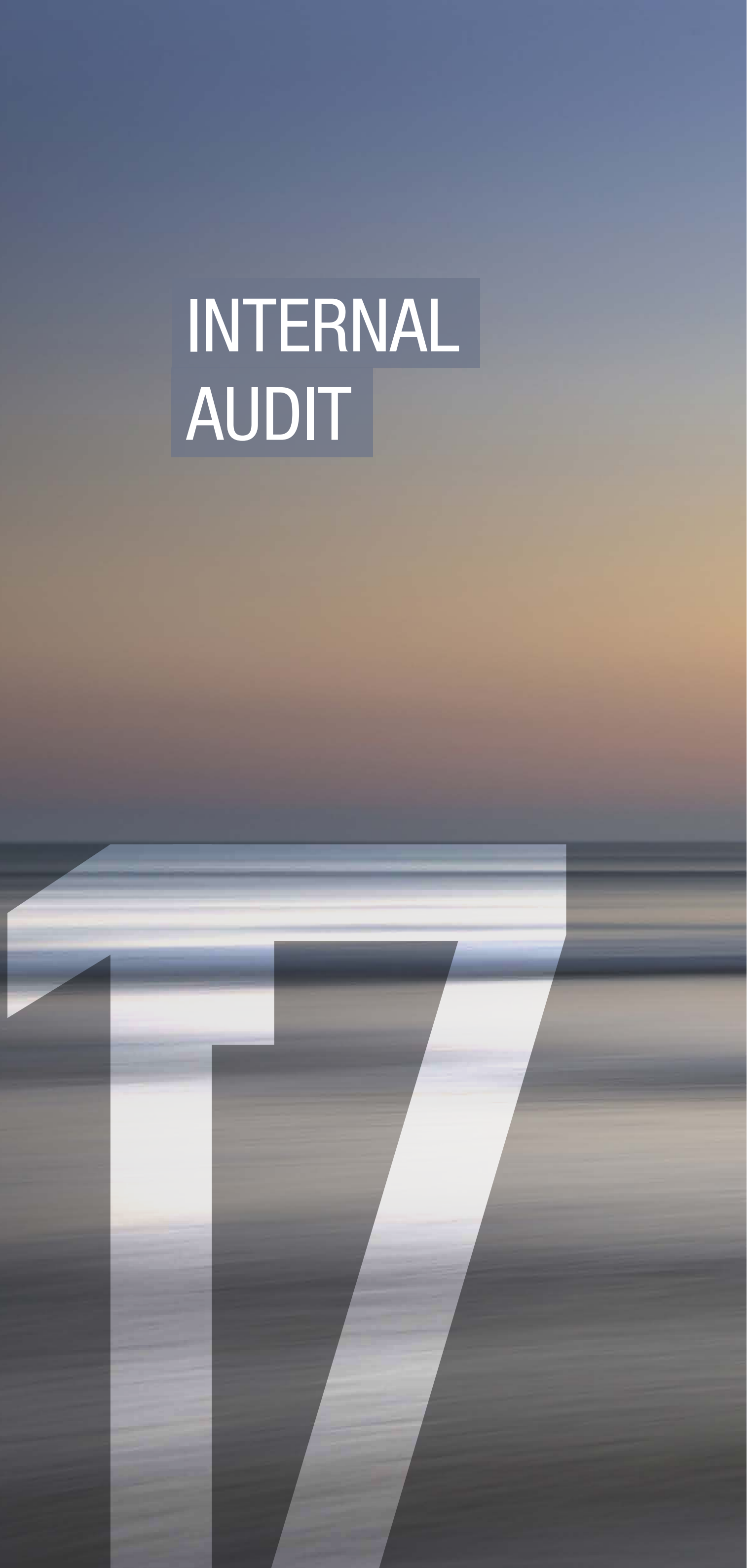
Membership fees paid by the FCMC to EU and global organisations in 2017-2018, in EUR

	2017	2018	Changes in 2018/2017
Payments to EU organisations	568,007	595,688	4.9%
Payments to international organisations	50,530	52,885	4.7%
Total	**618,537**	**648,573**	**4.9%**

In 2018, the intensity of business trips of FCMC staff for participation in the activities of the ECB, the EC and other bodies and organisations, as well as in the working groups for the improvement and coordination of supervision processes remained unchanged. In connection with the fact that at the end of 2016 the SRM became operational, as represented by the Board thereof, co-ordinating the functioning of the Deposit Guarantee Schemes of the Eurozone countries and in the organisational structures of which the representatives of the FCMC have been actively involved for the entire year 2018, the number of official business trips during the reporting year slightly exceeded 500 (the same as in 2017), whereas the costs thereof amounted to EUR 426 thousand. Also, the training related business trips abroad for the FCMC employees were ensured according to the needs and offers by training organisers.

The FCMC has been continuously improving the technical resources of the activity support thereof, particularly in the IT field; therefore EUR 118.5 thousand was spent on capital expenditure during the reporting year (in accordance with the cash flow principle).

The financial statements of the FCMC for 2018, approved on 07 May 2019, the financial statements of the DGF and FPI for 2018, as well as independent certified auditor's reports on them are available on the FCMC website www.fktk.lv.



INTERNAL AUDIT

Internal audit, by using a systemic and planned approach, provides the FCMC management with an objective and independent assessment of the effectiveness of FCMC governance, risk management and control system, including processes.

In order to increase the effectiveness of FCMC governance, risk management, internal control, as well as the effectiveness of the FCMC operational processes, the internal audit provides consultations and suggestions for the improvement thereof.

The internal audit function at the FCMC has been implemented by the Internal Audit Division, which consists of two employees (Head of the Division and Senior Internal Auditor).

Internal audit is organised and carried out according to the Internal Audit Policy approved by FCMC Board Decision No. 37 on 16 February 2017, as well as the Internal Audit Procedure approved by the Internal Audit Division on 29 November 2018. Internal audit is conducted in compliance with the Core Principles for the Professional Practice of Internal Auditing, International Standards for the Professional Practice of Internal Auditing and the Code of Ethics by the Institute of Internal Auditors.

Internal audit takes due care of the quality of the internal audit function; therefore its compliance with the International Standards for the Professional Practice of Internal Auditing and the Code of Ethics by the Institute of Internal Auditors is evaluated by an independent external evaluator every five years. In 2018, the external performance evaluation of internal audit was performed by SIA KPMG Baltics. The evaluation confirmed that the internal audit activity complies overall with the International Standards for the Professional Practice of Internal Auditing and the Code of Ethics by the Institute of Internal Auditors. The Internal Audit Division has developed and also maintains a current independent programme for quality assurance and improvement of the internal audit.

Internal audits are planned based on a risk-based approach and considering the strategic goals and priorities of the FCMC. The findings of the results of each audit are reported to the Board of the FCMC with a view to excluding the exertion of any influence on the results of the audit.

The Internal Audit Division conducts internal audits in accordance with the annual internal audit and consultation plan approved by the FCMC, which includes the audits scheduled in the audit plan of the Internal Audit Committee of the ECB.

In 2018, the Internal Audit Division conducted both the scheduled internal audits of the FCMC audit plan and internal audits in accordance with the audit plan approved by the Internal Audit Committee of the ECB.

The internal audit carries out a regular follow-up of the course of introduction of the recommendations provided, ensuring that the key recommendations are fulfilled and the control environment is correspondingly improved.

According to the requirements of Section 27 of the Law on the Financial and Capital Market Commission, the FCMC once a year – not later than on 1 July – shall submit a written report to the Saeima and the Ministry of Finance on its work in the previous year and a full annual financial report checked by a sworn auditor.

The audit of the financial report of the FCMC for 2018 was conducted by independent external auditors – SIA Ernst & Young Baltic.

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